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BOOK REVIEWS

Montgomery's Federal Taxes—Corporations and Partnerships—1949 - 1950

By Robert H. Montgomery, Conrad B. Taylor, and Mark E. Richardson. The RONALD PRESS COMPANY, New York, N. Y., 1950. Two volumes, pages: ix + 977-860. $20.00.

Frankly, despite the value of the text of these two volumes, almost everyone who has been familiar with them over the years looks forward with especial pleasure to reading Colonel Montgomery's Preface to each year's edition as it appears.

This year the Colonel offers a real treat—he will send a free copy of all his prefaces for the past thirty years if sufficient interest is evidenced to justify him in reprinting them. Such a collection will present a vivid history of the demand for tax reform, the recurring promises and excuses of Congress, and the unfailing failure to comply with these promises.

These volumes of Montgomery which are welcomed every year, have matured greatly. They have grown and changed with the years yet they have retained their essential characteristics so thoroughly that each year's edition adds to rather than differs from the previous one. The reader will, of course, find in this new edition all recent rulings and decisions with respect to the topics covered therein, as well as the pertinent earlier rulings and decisions still in effect.

An extremely valuable feature of this work is the fact that the decisions and rulings which are cited therein are either concisely and accurately summarized or preceded by a statement of the principle for which the case or ruling stands. In addition, the text is helpfully written under topical and subtopical headings. This treatment of the cases and of the text enables the reader to understand readily not only the fine point of the law but the "over-all" picture as well.

Locating information with respect to a particular tax problem is greatly facilitated by a complete general topical index; an index of decisions cited, and by various tables which are contained in each of the volumes. The whole work is so logically arranged that it is very convenient to review the entire topic which contains the detailed question under study. Corporate distributions, recognition of gain or loss, deductions for compensation (including pension trusts, annuities and deferred payment plans) are but a few of the general subjects which the reader will find to be most informative.

It is believed that the greatest value to be derived from this text is that from it the reader can most conveniently obtain the benefits of thirty years of study and experience in every phase of corporate taxation. Containing, as it does, invaluable expressions of viewpoint and innumerable suggestions regarding the best methods of procedure in dealing with tax problems, this work offers to the experienced practitioner as well as to the beginner the benefits of the research and experience derived from practice in that field since the income tax law was first enacted.

A brief but comprehensive summary of major developments and important decisions in the field of Federal taxation during the past year will be found in the foreword by the authors.

PAUL D. SEGHERS

New York, N. Y.

Montgomery's Federal Taxes—Estates, Trusts and Gifts (1949-50)

By Robert H. Montgomery, James O. Wynn, and G. Harold Blattmachr. THE RONALD PRESS COMPANY, New York, N. Y., 1950. Pages: x + 1145; $12.50.

This perennial handbook, encompassing within its scope all the estate and gift tax provisions of the Internal Revenue Code as well as those pertaining to the income taxation of estates and trusts, continues to be required reading for all practitioners in this field of taxation.

The provisions of the Technical Changes Act of 1949, which followed the decisions of the Supreme Court in the *Church* and *Spiegel* cases, as well as the amendments effected by the Tax Administration Act of 1949, have all been interpolated into the text; likewise, all important discussions and rulings, particularly those "which deviate from, or indicate a trend away from, previously generally accepted doctrines, which are in conflict with other cases or the announced position of the Treasury Department or which in the opinion of the authors are unsound or questionable."

The arrangement of the work remains unchanged and includes:

Part I—Methods of Estate Distribution

II—The Income Tax on Decedents, Estates and Trusts

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III—The Estate Tax

IV—The Gift Tax

Indexes.

The typography and the method of indexing and cross-indexing continue, as heretofore, to make this book a highly useful tool.

EMANUEL SAXE

Case Studies in Auditing Procedure: No. 7 —A Grain Company

American Institute of Accountants, New York, 1949. 58 pages, 50 cents; 25 per cent reduction for orders of 25 or more copies; special price of 25 cents per copy to accounting students enrolled in recognized colleges or schools.

This is the seventh of the studies sponsored by the Institute's Committee on Auditing Procedure. Like each of the others, it describes the auditing procedures followed by one practicing accountant in a particular engagement. The Committee points out that the procedures "may be applicable only due to particular circumstances surrounding the examination . . . " Readers are advised that "alternative procedures might conceivably have been used to accomplish the general audit objectives."

The pattern of the case studies is the covering of "an entire examination selected by the author from a case within his own practice." Actual procedures are described despite the possibility that an author might feel "upon reconsideration and with the benefit of hindsight" that certain changes in the program might have been preferable.

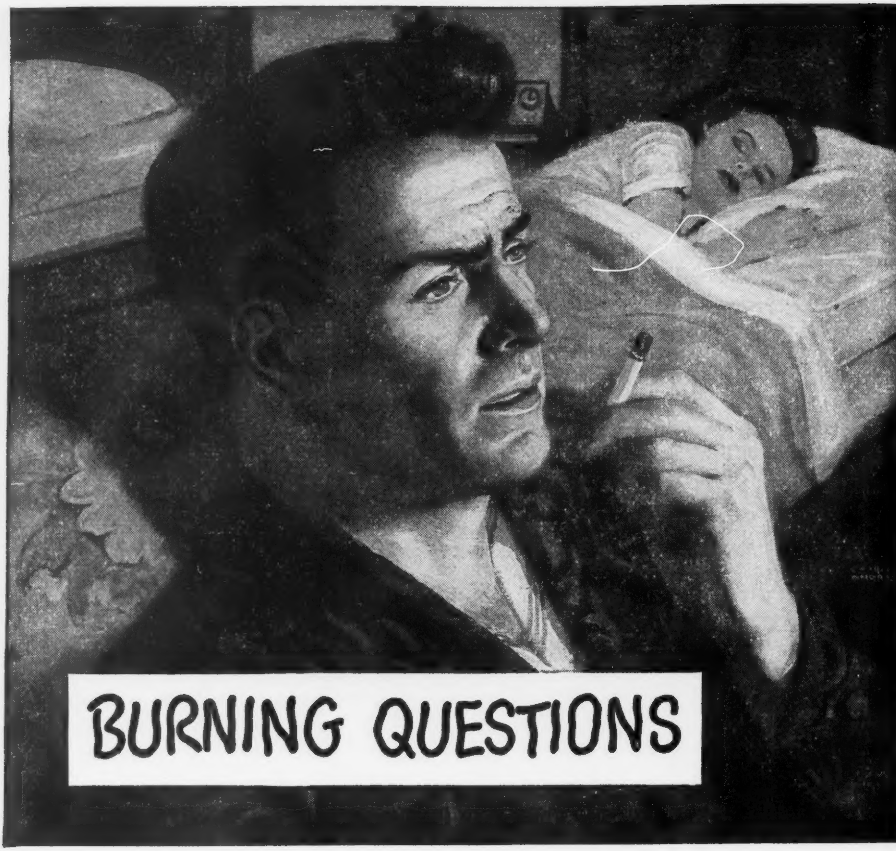
As to the size of the company under review—it owned or leased four terminal elevators and approximately seventy county elevators. A closely-held corporation, the net worth of approximately two and a quarter million dollars was vested principally in four officer-stockholders.

The study is presented under the following captions:

- History, nature, and organization of the business
- Hedging
- Major accounting and operation policies
- Preparatory planning of work
- Internal control and routine
- Audit procedures
- Client's written representations

In the section, "Preparatory planning of work," the participation of partner and supervisor is outlined. Also included is a most useful guide (on page 20) in the form of a tabulation showing the approximate percentages of staff audit time applied to

(Continued on page 137)


BURNING QUESTIONS

Book Reviews

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each of the sixteen subdivisions of accounting work—from planning to execution—making up the engagement.

The audit procedures are described in considerable detail under these classifications: Sales and revenues; Accounts receivable; Costs and expenses of operation; Inventories; Segregated customers' margin accounts; Property accounts, depreciation, and maintenance; Other assets; Prepaid expenses; Cash; Liabilities; Capital stock and surplus.

A Flow Chart of Grain Movement (page 22), which also indicates the documents involved, aids the reader in following the system of internal control.

This study, like the six which have preceded it in the series, is unquestionably useful to the profession and to students of advanced accounting.

LEO ROSENBLUM

The School of Business and
Civic Administration
The City College of New York

Lasser's Business Tax Handbook (Third Edition)

By J. K. Lasser. SIMON AND SCHUSTER, New York, N. Y., 1949. Pages: xxxii + 792; $5.00.

The 1949 edition of this famous Handbook should be in the possession of every practicing accountant who may be called upon to counsel his clients on tax matters (incidental to the preparation of tax returns, of course). The foregoing endorsement is not intended to imply that the more than 10,000 practical ideas contained in this handbook will help the accountant to do extended research in the field of taxation, for admittedly this is not its purpose. As a reference book for the tax practitioner the handbook is of somewhat limited value, since it does not cite cases or specific sections of the law, although most paragraphs are keyed directly to the applicable section of the Regulations; further, certain of the recommendations contained therein undoubtedly would require extensive research in order to determine the limitations to be set on such suggestions. However, in view of the wide-spread circulation of this manual, the practicing accountant will no doubt find himself confronted by many questions and new ideas which his clients have acquired as a result of reading various sections of the book.

With the author's usual thoroughness, he has organized into twelve extensive chapters almost all questions of taxation bearing on a business, from the moment that the venture is conceived in the minds of its organizers up through the time that it is laid to rest.

Inasmuch as the handbook is intended for the businessman and the layman, it would probably be helpful if the cross-referencing from one section of the book to another were to refer to pages rather than to chapters; the problem of finding the specific point of reference is made particularly difficult when it is noted that a single chapter may run to 116 pages. Also, the inclusion of tables of corporate and individual income tax rates would prove helpful to the reader.

It is believed that the Handbook will be valuable to accountants and tax practitioners in helping them to anticipate and meet the problems presented by clients who have read the book.

ABRAHAM J. BRILOFF

New York, N. Y.

Survey of New York Law (1948-1949)

Contained in the December, 1949, issue of the New York University LAW QUARTERLY REVIEW. (Volume XXIV, Number 5.) New York, N. Y.; pp. 965-1370, inclusive. Three dollars for this issue; five dollars per year.

This is the third volume in the annual series surveying New York law. It contains a comprehensive analysis of all statutes and decisions from June 1, 1948, to May 30, 1949. Its structure remains unchanged: there are seven parts, including chapters on State and Local Taxation, Trusts, and The Law of Succession, which will be of particular interest to accountants. This reviewer found the volume well worth reading.

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THE NEW YORK
CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

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The Fundamental Logic of Primary Variance Analysis

By LAWRENCE L. VANCE, C.P.A.

COST accountants are well agreed that standard cost techniques represent the best opportunity to achieve cost control without excessive expense. One prerequisite of an effective standard cost system is the analysis of variations between actual and standard costs which will permit management to ascertain the causes of aberrations and to fix responsibility. However, the formulas which are given in standard textbooks for variance analysis represent conventional, rather than logical, analysis to a considerable degree. This situation is unfortunate in four respects:

1. It prevents the student who is learning variance analysis from proceeding on logic alone, a situation which is always confusing and (deservedly) grounds for suspicion of a method.
2. It prevents the practicing cost accountant who has not successfully thought through the problem, from giving a convincing defense of his analysis.
3. In very rare cases when the analysis may be incorporated in a bonus computation, it may actually penalize one party to the contract unfairly.
4. It leads to erroneous adjustments of variance, where part is considered a loss due to inefficiency and part a necessary change in product costs.

LAWRENCE L. VANCE, C.P.A. (Minnesota and California), is Associate Professor of Accounting at the University of California. He holds the degrees of B.B.A., M.A., and Ph.D. from the University of Minnesota. He formerly served on the staff of Peat, Marwick, Mitchell & Company in Minneapolis, for six years. During World War II he performed special accounting work with McLaren, Goode & Company.

Dr. Vance has written for many accounting and tax publications, including The Journal of Accountancy, The Accounting Review, and the N.A.C.A. Bulletin.

This paper questions the practice of computing material price (or wage rate) variances on the full quantity consumed (or time expended) in manufacturing operations when a quantity (or time) variance also exists. A variance allocation procedure is set forth for use in determining variances in connection with responsibility for cost performance. It is also suggested that conventional variance separation results in erroneous costing when unfavorable price and quantity variances exist and the former is regarded as justifiable and so chargeable in standard costs. It is reproduced by permission, from Section One of the N.A.C.A. Bulletin for January, 1950.

Disclosing Variance Caused by *Both* Price and Quantity

The fact that very recent textbooks have continued the practice of offering the conventional analysis is the justification for the present article. The criticism of this analysis can be best developed with a simple example, built around variance in material cost. Suppose that Company Y used 2,500 units of material costing $2 per unit to manufacture a quantity of product for which the standard cost card specified 2,300 units of the material at $1.90 per unit. The variance which results may be computed as follows:

	Units	*Unit cost*	*Total cost*
Actual	2,500	$2.00	$5,000
Standard ..	2,300	1.90	4,370
Variance ..	200	$ .10	$ 630

If the analysis of the $630 variance is to be put on logical grounds, there seems to be only one approach to it. The reasoning must run as follows: The variance due to price alone can be identified with certainty only where no other influences are present, i.e. as if no variation in quantities had occurred. If material consumption had been standard in this case—2,300 units—our price variance would be:

10¢ × 2,300 = $230.

Similarly, the variance due to quantity used may be computed on the assumption that price did not change from the standard of $1.90:

200 × $1.90 = $380.

These two results, when combined, give the following picture:

Price variance	10¢ × 2,300 =	$230
Quantity variance	200 × $1.90 =	380
Explained		610
Unexplained		20
Total variance		$630

We do not have to look far for the explanation of the $20 difference. It is due to the fact that *both* price and quantity variances were present. It is their *joint product.* The complete analysis is as follows:

Price variance	10¢ × 2,300 =	$230
Quantity variance	200 × $1.90 =	380
Joint product	10¢ × 200 =	20
Total variance		$630

The conventional solution, it will be recalled, combines the joint product of price and quantity variances with the price variance, as follows:

Price variance:	
10¢ × 2,500 (actual quantity) =	$250
Quantity variance:	
200 × $1.90 (standard price) =	380
Total variance	$630

One is entitled to ask why the joint product should go into the price variance. The usual answer, though not explicitly recognizing a joint product, can be found in the statement sometimes offered to the effect that "the extra price was actually paid on all units used, not just on the standard quantity." But one could just as well make the opposite analysis:

Price variance:	10¢ × 2,300 =	$230
Quantity variance:	200 × $2 =	400
Total variance		$630

This places the joint product with the quantity variance. We could then say with equal assurance "the extra quantity actually cost $2 each, not just the standard price of $1.90."

Prorating Common Variance

Both statements are in error because they fail to recognize that a joint product exists. The fact that the joint product is conventionally thrown in with the price variance is apparently due to traditional acceptance of an original error. This situation may be disturbing to those who desire a clear-cut two fold division of the total variance, but the truth of the matter is that not *all* the variance can be said with abso-

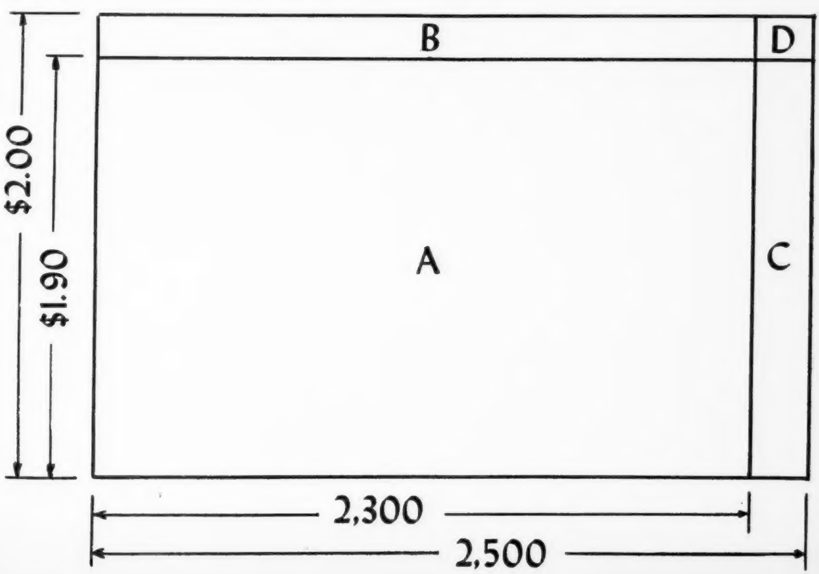
lute certainty to be due purely to either price or to quantity variation. Some of it arises because the two act together. The joint product is the *extra* price paid for the *extra* quantity used. Standard performance in *either* respect would have eliminated this variance. To attempt by purely logical means to divide this product between the two factors is equivalent to attempting to say how much of the product 6 is due to the 2 and how much to the 3 which were multiplied to get it.

However, there is a reasonable basis for dividing the joint product where it is necessary to do so for purposes of assessing responsibility. From the analysis which recognizes the joint product, we know how much of the total variance can be attributed *solely* to price and how much is due *solely* to quantity. It would seem reasonable to divide the joint product in the ratio of these amounts which are definitely attributable to price and quantity influences, since the result is to divide the total variance into those proportions. This is not a solution which flows automatically from the logic of the mathematics, for there is no such solution, but it appears to be an appropriate means of making a twofold analysis for purposes of assessing responsibility for performance under standard costs. By this method, the analysis takes on the following form:

		Original analysis	*Allocation of joint product*	*Final allocation*
Price variance:	10¢ × 2,300 =	$230	$ 8*	$238
Quantity variance:	200 × $1.90 =	380	12*	392
Joint product:	10¢ × 200 =	20	(20)	——
		$630	-0-	$630

* To the nearest dollar in the ratio of 23/61 and 38/61.

The reader may find this whole presentation more understandable in graphic form. The analysis may be presented graphically in the form of a rectangle containing four lesser rectangles.



The rectangle marked "A" represents standard cost and has as dimensions the standard quantity of 2,300 and the standard price of $1.90. The sum of all the rectangles is actual cost. Its dimensions are 2,500 units and $2. The total variance is measured by the areas B, C, and D. Rectangle B is the extra cost due solely to the extra price of ten cents. Rectangle C is the extra cost due solely to the extra quantity of 200 units. Rectangle D is the joint product of price and quantity variances. It represents the amount we allocated to B and C in the ratio of their individual areas. (This graphic presentation is simplest, of course, where all variations are over standard.)

Variance Analysis When One Variation is "Justified"

The analysis given above enables management to assess fairly the dollar amount of loss caused by the failures of the responsible persons. In addition, we must consider the need to adjust the product costs where one or both variations are justified and the cost card is to be correspondingly changed. Since the conventional analysis is offered for this purpose, too, it will be well to inquire into its reliability in this respect.

Where neither variation is justified, the whole variance may be written off to the general income account as a loss. Where both are justified, the whole amount may be used to adjust product costs. Where one is justified and the other is not, the variance must be divided for purposes of the adjustment. This condition is most likely to occur (at present) where price is over standard because the general market for material or labor rates is up. In these circumstances the cost card must be changed and the variance will also change. The variance remaining will be all due to the quantity variation.

Reference to the example given above will disclose that this remaining variance will be equal to that part of the original variance which was due solely to quantities plus the original joint product, which thus appears to be assessed entirely to quantity. However, this results from changing the standard price, i.e. the price paid becomes standard, and no price variance exists. The conclusion reached in this paper as to the proper treatment of a joint product of variance for assessing responsibility where two positive variations exist due to inefficiencies, is not affected. It is indicated, however, that wherever the price variation is determined to be a justifiable one, the amount to be written off to profit and loss as due to inefficiency is the quantity variation times the new price, not the quantity variation as calculated where the joint product is recognized and prorated.

The part of the variance due solely to price as originally analyzed is the amount to be adjusted to inventories and cost of goods sold. This leads to a very interesting conclusion, namely, that in a typical case where the price variance is justified and the quantity variance is not, the conventional analysis tends to cause an erroneous adjustment. This is true since the suggestion has been made that the price variance as determined by conventional analysis be used to adjust product costs where the price variation is justified. Since this price variance includes the joint product it is evidently the wrong figure for the purpose.

Continuation of our illustration may help at this point. Referring again to the data used earlier in this paper, we may make the following tabulations, shown in Exhibit I. Of course, the probability that an error will actually be made in separating and charging justified price and inefficiency use variances depends upon whether or not an over-all proration of the price variance to inventories (presumably in valuation accounts) and cost of goods sold is employed or whether the standard cost for the item is first adjusted and a new variance determination made. Detailed application of the new price in the

stores accounts would give the correct adjustment by giving the new standard as a starting point.

A little experimentation with the arithmetic of similar examples will demonstrate to the reader that whenever one element of variation is determined to be justified and it is desired to adjust the cost card and the inventory accounts accordingly, the amount of the adjustment to product costs will be the amount calculated as due solely to the justifiable variation in the original analysis. The amount remaining, to be charged to profit and loss as representing the result of inefficiency, will be the sum of the joint product of the variances in the original analysis and the portion of variance identified as due solely to the unjustified variation.

This holds good when one variation is negative and one positive and when both are negative. (In analyzing variances where one or both variations are negative, it must be remembered that the rules of algebra apply to the computation, i.e., a negative times a positive gives a negative product, and a negative times a negative gives a positive product.) Since price variations are presumably most often justified and quantity variations are not, the conventional analysis will give wrong figures for the adjustment in the ordinary case. In the rare case where price variations are not justified but quantity variations are, it will give the proper figure.

Variance analysis:

Original analysis:			
Price variance:	10¢ × 2,300 =	$230	Before revision of standard.
Quantity variance:	200 × $1.90 =	380	$400 (see below)
Joint product:	10¢ × 200 =	20	
		$630	

Variance if standard price is changed to actual:			
Actual:	2,500 × $2 =	$5,000	
Standard:	2,300 × $2 =	4,600	
	200 × $2	$ 400	Quantity variance only (see above)

Adjustments to reflect change of standard:

Adjustment to product costs:			
Original standard recorded:			
2,300 × $1.90 = $4,370			
New standard:			
2,300 × $2 = 4,600			
Adjustment (debit)		$230	Charge costs at standard
Write-off as inefficiency loss:			
Quantity variance (debit)		400	Charge to variance in profit and loss
		$630	

Adjustment indicated by conventional analysis:		
Price variance	$250	Charge costs at standard
Quantity variance	380	Charge to variance in profit and loss
	$630	

Exhibit 1

Labor and Burden Variances

The same statements may be made about labor variances. Labor variances are conventionally analyzed in terms of labor hours and labor wage rates, to afford price and quantity factors like

those employed in materials variance analysis.

It is likewise possible to make the same comments about overhead variance if overhead variance is placed upon the same basis as materials and labor variance analysis by using direct labor hours or some other overhead distribution base as the quantity element and the overhead rate per hour as the price element. In this case, the standard hours will have to be those required for the product turned out as indicated by the cost card and not the total budgeted hours.

However, the conventional analysis of overhead, which is achieved by taking the total budgeted costs and hours into consideration, does not proceed along the same lines as material and labor variance. It arrives at a threefold instead of a twofold analysis, consisting of budget, capacity, and efficiency variances. In this, the efficiency variance is the same as the quantity variance of the twofold analysis and the budget and capacity variance divide the remainder in a different manner from the price and joint product variance given by the twofold analysis.

Summary

We thus arrive at a final consideration of the proposition stated in the opening paragraph of this article. The student who is given only the conventional analysis of material and labor variances will either avoid thought on the subject or be confused because he cannot reason it out logically. Consider also the case of a practitioner who presents the conventional analysis of materials variance only to have the purchasing agent complain that part of what has been charged to his failure to buy at standard prices belongs to the operating executive who incurred the cost by using excess quantities in production.

Further, it is conceivable that a scientifically-minded management might write a bonus agreement with a plant manager in which the bonus was to be calculated as a specified figure, less any variance due to use of excess quantities. In the conventional analysis, the company would pay too much, since part of any joint product of unfavorable variation is due to quantity variation but none of it is allocated to the quantity variance. A contract with a purchasing agent based on price variance would give the opposite result.

Finally, the conventional analysis gives an erroneous adjustment of product costs where a price variation results in a change on the cost card and the adjustment is handled on an overall basis and an unjustified quantity variance is also present. The present writer has observed the difficulties of neophytes who continue to be given only the conventional analysis and he is, therefore, convinced of the need to present and emphasize the fundamental logic involved.

Bank Costs

By Herbert E. Kirmmse, C.P.A.

Two members of a large credit union, which is a sort of cooperative bank, were discussing its operations. "I don't know how the credit union does it," observed one, "they charge only three per cent on loans and pay the same three per cent as dividends on share capital." After pondering a bit, the other member remarked sagely, "The answer is—terrific volume!"

These members obviously did not realize that the loan rate was three per cent *discounted* which, on instalment loans, would yield an effective return of nearly six per cent per annum.

The belief that terrific volume means terrific profits is still accepted in more than one bank. It is true that inflation has brought increased deposits, but it also means more clearings to handle at higher costs at the very time when income is depressed by artificially low interest rates. Thus banks today find themselves caught in the middle—they are being squeezed between pegged interest rates on earning assets on the one hand and rising costs of operation on the other.

This state of affairs and the unlikelihood of any early improvement in the trend is reflected in the market value of bank stocks which have been quoted generally below book or realizable value. Public attention was recently directed to this situation when the stocks of five various banks suddenly rose from market to book value as a result of purchase by or merger with another institution.

A further reason for the apathy of prospective investors to bank stocks may be that banks have been obliged to build up the greater part of their capital funds from earnings, a process that leaves less for distribution to the stockholders. After all, stockholders' living costs have gone up, too!

The difficulty in raising fresh equity capital is evident from data in the 1949 Annual Report of the New York State Superintendent of Banks. An analysis of the sources of capital funds of New York State banks and trust companies from the end of 1936 to mid-1949 discloses that retained profits were responsible for most of the $452 million rise in capital accounts during that period.

How will banks approach the problem of maintaining vitally needed net earnings in the face of static gross revenues and expenses creeping ever higher? This situation presents a phase of operations, *determination and control of costs,* with which independent accountants have had conspicuous success in various kinds of business, and in which specially equipped certified public accountants are making growing contributions in the banking field.

It is the purpose of this article to discuss some of the ways in which members of the accounting profession can profitably assist alert bank managements (1) to know their costs, (2) to control their costs, and (3) to reduce their costs, without impairing efficiency or morale. Specific cases will be cited where banks increased income materially as a result of cost knowledge. The authoritative data thus made available justified raising fees and charges. In other instances it will

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be shown that cost determination and control were equally as important where, due to economic and competitive factors, chances of increasing charges were slight.

Cost Control Needed For Sound Banking

The emergency "bank holiday" in 1933 and the disruption of business that followed, furnished convincing proof that bank credit is the lifeblood of commerce and that in America 95 per cent of all business is transacted by check. Nobody today questions that strong, sound banks are indispensable to the proper functioning of the economy.

Any development or trend, therefore, which may have an adverse effect on the condition of our banks warrants close study and the application of corrective measures.

A situation does confront the banks currently, rising costs, which calls for expert attention, especially in view of the refusal of revenues to absorb the rise. This is the type of problem that invites the analysis and remedial recommendations of qualified certified public accountants.

Conceding that the fundamental objective is to keep the banks strong, then it should also be recognized that:

1. Capital position should be maintained and increased commensurate with deposit growth and investment risks assumed.

2. If the pattern of the past decade is to continue, additions to capital will come chiefly from net earnings.

3. If gross earnings cannot be increased, adequate net earnings can only be achieved by controlling costs.

4. In an expanding economy and the uncertainty of the ultimate consequences of "managed" inflation, costs are much more likely to go up than down.

5. Banks, like other businesses during the war and post-war boom, have doubtless permitted some degree of inefficiency and an undetermined amount of non-productive expenses to infiltrate their operations; break-even points are mounting persistently.

6. Independent certified public accountants are equipped by training and experience to ferret out and spotlight useless activities, unnecessary duplication of records, faulty procedures, and bottle-necks in the flow of work. They can aid cost-conscious bank managements by pointing out where costs may be reduced and by testing each expense dollar for value received.

Know Your Costs

Accountants and bankers who have given special attention to bank cost analysis agree unanimously that the approach to the subject of bank cost control is first to "Know Your Costs."

According to H. E. Randall, Vice President of the First National Bank of Boston, banks are not using scientific pricing methods because they are not sufficiently informed about costs. An investment in cost knowledge of every phase of the bank's business, he noted, would pay worth-while dividends. Many bankers are guessing without having cost facts or are blindly following the other fellow in setting sales prices.

Mr. Randall observed that banks which have determined their costs, found that most of their small accounts —checking, savings, trust, personal loan, safe deposit—were operated at a loss, and as a result of that knowledge they have increased their over-all earnings substantially.

With cost data available, he continued, measuring sticks can be used to determine the profitability of any account or group of accounts and corrective action can be taken where warranted. In most cases reviewed by Mr. Randall, it was necessary, for example, to increase service charges on checking accounts and charge trust principal for a part of the fee rather than rely entirely on income fees. A cost analysis of

trust, agency, and estate accounts indicated the necessity for special fees. In this connection, the use of common trust funds has lowered operating costs and permitted lower fees to customers.

With respect to savings departments, further results of information on costs showed the need for service charges for excessive withdrawal activity and the elimination of interest on small savings accounts. Many banks discovered that small personal loans, usually believed to be profitable because of the higher interest rates, were actually handled at a loss. In such cases, the law permitting, a minimum discount charge could be made.

Suspicion in the public mind that many banks did not know their costs was demonstrated, at least to some extent, by the wide variations between costs and service charges reflected in a special study completed in 1945 by the New York State Superintendent of Banks. He reported that the New York system of service charges had grown up in haphazard fashion, and that the relationship of charges to costs was "highly dubious and well-nigh impossible for the public to understand." It was found that less than half of the banks that made service charges had made cost analyses. Fewer still had made recent studies.

Subsequent to these findings, the New York State Bankers Association and the American Bankers Association authorized and published special studies which have made available valuable additions to the field of bank costs. These publications present basic standards for measuring charges in a manner as uniform and understandable to the public as possible for a subject which is more complex than simple.

One of the reports, "Current Trends In Bank Costs", just completed by the Country Bank Operations Commission of the ABA emphasizes "the tremendous variations of costs for items and transactions as among the various banks . . . caused not only by the actual expenses involved, the activity, efficiency and policies, but also by the differences between the methods used in arriving at costs."

The report concludes that current derivation of cost figures is but the first step to proper interpretation and constructive action to be taken based upon the data obtained. Banks are warned to give careful consideration to the important factor of public relations before following any policy dictated by cost figures alone.

In another study of checking account costs of 17 country banks in Wisconsin made under the auspices of the Bank Management Commission of the Wisconsin Bankers Association, it was discovered that account maintenance costs for various reasons ranged from 5¢ to 48¢ per month, item costs for "on us" checks ranged from 1.23¢ to 3.78¢ each, clearing house checks ranged from 1.08¢ to 2.88¢ each for handling, transit checks from 1.15¢ to 4.67¢ each, and deposit tickets from 2.92¢ to 9.28¢ each.

With such variations, is there any wonder that the public is often resentful of charges assessed for services which the bank itself is frequently at a loss to explain satisfactorily? From the public relations aspect alone it is surely worthwhile for a bank to be in a position to demonstrate to its customers the bases for its various charges, secure in the knowledge that they have been accurately and fairly determined.

How big a job is bank cost finding? Is it worth the trouble and expense involved? How can certified public accountants work with banks and trust companies—as they have for years with industrial firms—in establishing costs, revising them, and, insofar as possible, forecasting costs for budgetary purposes?

Cost finding can be both over-simplified and ultra-complicated. Neither course is desired by any financial institution nor would it be recommended by consulting accountants. There is a proper cost installation depending upon the size of the institution and the type of its business.

In every case, according to the Wisconsin study referred to above, there must be determined a minimum overall picture to insure accuracy of costs for even a single function but it is not necessary to determine detailed costs for every function. Various steps cited to establish a cost program are:

1. Preparation of an average balance sheet.
2. Compilation of activity statistics.
3. Preparation of a cost profit and loss statement.
4. Preparation of a conversion fund report.
5. Functional allocation of income and expense.
6. Allocation of expense to primary functional components.
7. Determination of unit or item costs.

As in any cost program, the primary objective should be to take as much of the guesswork as possible out of operations by avoiding the attitude of hoping that the final net return will prove satisfactory. Bankers are entitled to be informed currently, wherever feasible, of the detailed earnings and expenses attributable to each department in the bank. This should be further refined to show the costs of handling each transaction and each type of account so that intelligent judgment—not unintelligent guesswork—will be the basis for setting sales prices.

In these days of intense competition, not only among banks with each other, but also between banks and other lenders, such as insurance companies, and the government itself, decisions must be made on time and with good judgment. Such decisions, however, cannot be made unless bank managements are kept correctly and promptly informed of the results of operations.

It should be made clear that the accounting system should not be designed solely to provide the objectives of ready cost determination and adequate availability of cost data. A well-rounded system must incorporate features which will yield other essential information to management in the form of concise statements and reports. The principles of internal check also cannot be overlooked.

Cost Control and Reduction

"The object of cost control is to retain as much of the gross income as possible without impairing efficiency or endangering the financial structure." This succinct statement comes from E. S. Woolley, C.P.A. specialist in bank management, who added that "Any expense in a bank is a cost. Until this basic fact is recognized, cost control, with its parallel, adequate profits, is impossible for any bank to attain."

But the statement made by Mr. Woolley that deserves the most applause, and one which should be recognized with special satisfaction by bank personnel, is that while salaries represent an expense subject to reduction "individual salaries should not be cut, but total payments may be reduced without cutting and perhaps even increasing individual salaries." This aim could be attained by increasing individual work output and effectiveness and by eliminating outmoded operations, reports and methods.

It is the firm belief of the writer, based upon personal experience, that once bank employees are assured that cost control, efficiency audits, and the like, will not result in cutting individual salaries, they will give much more whole-hearted cooperation to implement these aids to operation and management. As a matter of fact, no real progress can be made in establishing true costs by means of time studies, flow of work, and the like, without the entire bank staff being taken into confidence and encouraged to participate in the analysis. When completed, the findings of the survey should, insofar as practicable, be divulged to the personnel from whom any suggestions or recommendations should be welcomed. It

must be remembered that many employees of the bank deal more often and more closely with the public, over the counter and via telephone, than do some of the officers whose contacts are apt to be limited to their opposite numbers in industry.

Before commencing a general cost study, consideration should be given to this important aspect of employee relations. The consulting C. P. A. firm might be asked to indicate the need for any changes in employee incentive and merit rating plans. As a result of a complete cost analysis engagement, the accountants may recommend a general job evaluation program and the establishment of a budget.

The value of a budget is impressive in the light of a cost analysis study. Only with such a forecast of operations and condition can the most profitable functions—and the least profitable—be brought into proper focus, and rewards meted out to those responsible for superior achievements.

Budgetary cost control, operated in conjunction with monthly accruals of the major income and expense items, permits comparisons to be made currently with prior performance, competitive standards and desired expectations. Such comparisons, by highlighting any serious deviations, make corrective action possible before serious damage is done. Proper budgetary control enables management to open the throttle (or close it down) to make decisions in time to avoid possible loss on the one hand and, on the other, to take advantage of opportune profit possibilities.

The budget fits into a cost analysis program by showing up existing weaknesses in operations which may be susceptible to immediate rectification. For example, an unusual increase in the cost of running the collection department may mean that collection charges should be revised or that internal efficiency has deteriorated.

Reduction of costs should not be made without regard to maintenance of the safety factor or by sacrificing vital information. But a thoughtful review of the detailed make-up of every classified expense, reflected on the debit side of the profit and loss account, indicates specific places for cutting costs.

The following suggestions are listed without attempting to set forth every possibility for reducing expenses:

Tellers

Has the work productivity of the tellers been determined? Are there too few or too many tellers? Do they have idle time which could be utilized by another department? Are the customers satisfied with the services and are they paying adequately for them? Is the physical layout of the cages conducive to efficient operations? Would additional mechanization be warranted?

Loans and Discounts

Is the loss ratio low but are collection costs too high? Are records unnecessarily duplicated or triplicated? Has the rate on consumer loans been mistakenly reduced just to meet competition? Are sufficient compensating balances carried? Would the purchase of more modern machines be justified?

The Bank As A Whole

Should there be a general departmental reorganization? Can the work be simplified, methods streamlined, the chart of organization strengthened, employee morale improved, free services reduced, peak loads better handled, purchasing economies gained, and excess reserves and other idle funds minimized?

These are some of the fertile places for savings which the accountant-analyst will examine critically. He will review in his mind alternate methods successfully used in other banks and suggest that they be given consideration by his present client.

Some banks have designed their cost analysis plan and set their charges at a level which would recover expenses but not provide for a reasonable profit. The

fallacy in this type of program was pointed out in an address at the New York State Bankers Annual Convention on May 25, 1942, by John J. Driscoll, C.P.A., who specializes in bank management analysis. He recommended that the desirable profit could be effected by:

1. Using a higher than actual reserve deduction.
2. Reducing the rate of allowable income credit on invested balances.
3. Setting charges at "selling prices" rather than cost.

In his same address, Mr. Driscoll correctly predicted that activity costs would increase at a faster pace than income, a development which would emphasize the need for increased service charges if reasonable earnings were to be approached. As a result of his cost findings on personal loans, deposit accounts, and other activities, he made various specific recommendations that have since proved their worth to the banking institutions concerned.

While all of the foregoing comments are applicable to the bank as a whole, there are many reasons for considering the trust department separately. Many banks have no trust departments; others maintain small departments solely to accommodate their customers, while an important segment of banks actively promote trust business. Accordingly, the problem of trust department costs warrants special consideration.

Trust Department Costs

Too many banks have operated their trust departments as a necessary sideline, an adjunct to the general banking business, which they hoped would add a little something to the net income at the year end. More often than not, cost analysis would have shown that trust services were actually rendered at a considerable loss to the bank. When this unsatisfactory situation is given further consideration by the directors, added to the ever-present possibility of successful litigation for surcharges, it would not be surprising if a number of the smaller banks decided to dispense entirely with their unprofitable trust business.

For those institutions which continue to offer trust facilities, particularly where income is more or less fixed by statute, expenses must be controlled if a profit is to be realized. In cases where it is almost certain that the trust department will be operated at a loss, the application of cost accounting will show the extent of the loss and indicate where the loss can be controlled or reduced to a minimum. Even more important, reliable data will be available for presentation to the State legislature whenever action is taken to revise statutory trust fees.

Four essentials of trust department expense control, outlined by George C. Robinson, trust operations officer of the Fidelity Philadelphia Trust Company, are:

1. Cost accounting
2. Activity control
3. Budget
4. Strong management

Cost accounting provides the essential detailed expense information needed to point out inefficiencies and to develop item costs.

As trust expense is related to the degree of activity, the bank should try to reduce the number of remittances and statements to beneficiaries. Where feasible, common trust funds should be used.

The budget, as a pre-determined statement of income and expenses, is comparable to a navigation chart. It serves as a guide toward the objective which, in business, is net profit. A budget checks leaks, and prevents improper enlargement of services.

Strong management, concludes Mr. Robinson, should make the staff constantly expense conscious.

Certified public accountants have given increasing attention to the cost accounting problems of banks acting in their capacity of personal and corporate fiduciaries.

In a recent talk before the Fiduciaries Section of the District of Columbia Bankers Association, Colin MacLennan, C.P.A., Chairman of the Society's Committee on Bank and Trust Company Accounting, noted that a surprisingly large number of institutions had apparently not considered it sufficiently important to provide for an adequate reporting of trust department operations by application of a cost accounting system. In his talk, the speaker outlined a practical course for bankers to follow when faced with a lack of adequate accounting and cost data. He also demonstrated how the information should be developed and utilized.

An important point emphasized by Mr. MacLennan is that while the accountant can show how the principles of cost accounting can be applied, it is the function of management to evaluate the data made available for its consideration. The knowledge of costs should be viewed as a tool which will provide management with a valuable aid, but will not substitute for the exercise of sound judgment.

With bankers becoming more and more concerned with cost factors, it is natural that they will look askance at trust departments which do not carry their own weight. Certainly, the first step in any intelligent appraisal of the situation calls for a carefully made cost analysis to determine what moves should be made to eliminate any loss and place the trust department on a profitable basis.

It is surprising to note the number of cases where inadequate rates contracted for under older voluntary agreements have been successfully renegotiated. Bank officers were able to obtain the increase in fees by tactfully presenting the customer with account analysis data showing the effect of the change in conditions and increased costs.

In numerous instances, a survey of trust costs resulted in the discontinuance of free services, the establishment of adequate charges, and the adoption of fee schedules designed to compensate the bank equitably according to the type of service furnished.

It is expected that the field of trust department cost analysis will offer attractive opportunities to independent certified public accountants specializing in this work.

By-Products of Cost Analysis

Some of the by-products of a cost study have proved as valuable as the primary findings themselves. For example, one analysis resulted in improved supervision and the fixing of responsibility which had been lacking before. Another result was the establishment of performance standards for the various jobs with the consequent knowledge and satisfaction that both the bank and the customer were getting their money's worth.

Other achievements and recommendations which have arisen from cost analysis were a better measurement of operating results, tax advice, adoption of revised accrual accounting, and advocacy, where advisable, of the reserve method of accounting for bad debts for income tax purposes.

Besides installing new cost systems and prescribing needed revisions in existing systems, C.P.A. analysts are in a good position to give unbiased advice concerning the type of accounting machines best adapted for mechanizing operations. The use of carefully chosen cost-saving equipment can result in a considerable reduction in expenses.

Summary and Conclusions

The role of certified public accountants in banking has been confined chiefly to the certification of financial statements furnished by borrowers for credit purposes, and the performance of routine directors' examinations.

Efficiency audits, appraisals of methods and procedures, cost analyses—all are relatively recent services which banks have sought from specialized accounting firms. Only a beginning has been made in this direction.

Why have not banks availed themselves more widely of accountants' aid? Why have not accountants in turn put forth greater effort to acquaint banks with all their wares?

The answer appears to rest on several inherent and important factors. First—banks are subject to at least annual examinations by state and federal authorities. In addition, there are statutory examinations by directors, usually every six months. Then there are internal spot audits made to minimize the possibility of fraud and irregularities. Usually the accounting system is designed to provide for a maximum of internal check. Bankers have ample justification for their contention that they are over-examined.

Underlying all these characteristics of the banking business is the necessity for a tremendous and continuous accounting job. For example, deposited checks are recorded in the receiving teller's cage and form part of his daily proof. From there the checks go to the clearing and transit departments where they once more find their way on lists and proofs. If the checks are drawn on the bank which received them, they are charged to the depositors' ledgers where they again furnish the basis for entries and proofs. The public and the supervisory agencies expect banks to keep clear and complete records. This expectation has been admirably fulfilled—at more and more expense to the bank.

Probably the greatest deterrent to the full use of the facilities of specialized certified public accountants is the cost factor. It is ironical that a great industry, banking, which may most need the counsel of cost-wise accountants, chooses to forego it for the reason "can't afford it." It is hoped that this article has in some degree exposed the error of such a view by showing that what banks actually cannot afford is to overlook possibilities of:

1. Determining and controlling costs of the bank as a whole, of each department and function within the bank, and of each unit of activity within each department.
2. Reducing costs of operation consistent with maintenance of efficiency and safety.
3. Increasing uneconomic fees and charges.
4. Equitable revision of trust fees.
5. Holding department heads accountable for performance standards through budgetary control.
6. Tax savings.

Concerning the tax phase alone, certified public accountants have had occasion to save banks considerably more than the cost of the engagement. In one case which comes to mind, acceptance of the accountants' recommendation that specific action be taken before the close of the year to establish long-term gains on certain taxable securities resulted in substantial tax saving. In this instance careful thought had to be given to many aspects, including the obvious fact that income on the bonds sold would have been taxable at a higher figure than at the capital gains rate. The question was also considered whether capital losses should have been taken to offset ordinary income and the capital gains postponed. Finally, the question of reinvesting the proceeds at a lower yield demanded consideration. These situations involving various courses of action in which the tax feature is predominant are dealt with more frequently and consequently more expertly by accountants than they would by many bankers.

As recognition grows among bankers of the value of scientific cost analysis, and as the application of its principles becomes more widely accepted, it can be expected that interchange of cost data, based on substantially uniform ap-

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Tax Treatment of Payments to Widows of Deceased Employees

By Benjamin Harrow, C.P.A.

Employers, in recognition of faithful services rendered in the past by their employees, often make payments to the widows of such employees after their death. In some cases such payments are made pursuant to a contract entered into between employer and employee. In other cases, such payments are made voluntarily by the employer pursuant to a pre-established plan. Sometimes the payments are authorized only after the death of the employee, by corporate resolution or otherwise. States and other governmental units sometimes make provision for widows of their employees. Do such payments constitute tax deductions for the employer? Are they taxable to the recipient? Let us first consider the question of the deductibility of the payments.

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This paper was presented by Mr. Harrow at a meeting in the Society's lecture series on Federal Taxes, held November 30, 1949, in the Engineering Auditorium, New York.

Deductibility of Payments

Section 23(a)(1)(A) of the I.R.C. provides that in computing net income there shall be allowed as deductions

> "all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; . . ."

Section 29.23(a)-9 of Reg. 111 reads, in part, as follows:

> "Amounts paid by a taxpayer for pensions to retired employees or to their families or others dependent upon them, . . . are proper deductions as ordinary and necessary expenses. When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs, in recognition of the services rendered by the individual, such payments may be deducted."

It is well established that a deduction may be taken in a current year for salaries paid in consideration of services rendered in the past.[1] Similarly, payments made to a widow for services rendered by her deceased husband may also be deducted. Regulation Section 29.23(a)-9, quoted above, specifically provides for the deductibility of salary payments to the widow or heirs of a deceased officer or employee for a *limited period,* in recognition of past services rendered. While this provision first appeared in Regulation 45, under the Revenue Act of 1918, and has remained more or less without change in subsequent regulations, the limitation

[1] *Lucas* v. *Ox Fibre Brush Co.,* 281 U.S. 115:

"The statute does not require that the services should be actually rendered during the taxable year, but that the payments therefor shall be proper expenses paid or incurred during the taxable year."

on the period within which deductible payments may be made has not been expressly defined.

The fundamental right to the deduction of payments made to the widow of a deceased employee must come from Section 23(a) of the I.R.C. In other words, it is necessary for the taxpayer to justify the deduction as an ordinary and necessary expense of carrying on a trade or business. This was so held in the case of *McLaughlin Gormley King Co.*[2] In that case, periodic payments to the widow of Alexander McLaughlin were allowed as deductions from July, 1939, through November, 1941, a period of 28 months. The Commissioner disallowed payments to the widow subsequent to November, 1941, as being beyond the "limited period" referred to in Regulation Section 29.23(a)-9. The Tax Court decided that in the absence of (1) a contractual liability, (2) an established pension policy, or (3) a showing that such payments were for past services and were reasonable in amount, the payments could not be deducted under Section 23(a). The taxpayer contended that the Commissioner had no authority to deny the deduction merely upon his own determination of what constituted a "limited period" under the regulation, but the Tax Court concluded that the taxpayer had failed to prove his right to the deduction under Section 23(a). Once the Commissioner has disallowed the deduction, the burden of proof is on the taxpayer to show by competent evidence that the payments were ordinary and necessary expenses. Failure to overcome the presumption raised by the Commissioner's disallowance of the deduction will be fatal to the taxpayer's case.

In *Mobile Bar Pilots' Association,*[3] a deduction for payments made to the widow of a deceased pilot as additional compensation for services rendered by the pilot, was disallowed as not being shown to be reasonable in amount. The Court said,

> "There is no evidence in the record showing that such amount was reasonable additional compensation for the services rendered by him prior to his death. Petitioner's failure to establish this vital fact is fatal to his contention on this issue. Moreover, there is also no evidence in the record establishing the fact that this payment was an 'ordinary and necessary' expense of the business."

In *Seavey & Flarsheim Brokerage Co.,*[4] one of the petitioner's employees was in charge of its St. Louis branch. The employee was regarded by petitioner as one of the most valuable men in the food industry. He became dissatisfied with the terms under which he was working and contemplated leaving the employ of the petitioner and going into business for himself in order to build up an estate which he could leave to his wife. He was sixty years of age at the time. The officers of the petitioner were advised of the situation and, after negotiations with the employee, a contract was entered into in 1928, whereby petitioner agreed to pay a maximum of $12,000 per annum for life to the wife of the employee upon his decease out of the net earnings of the St. Louis office. The employee died in 1931, two and one-half years after the execution of this agreement, and the petitioner began to make payments to the widow. The Commissioner disallowed the deduction for the year 1934. The Board in holding for the petitioner said:

> "Obviously, this was additional compensation for his services. There is no contention that the $12,000 was a gift by petitioner or that it was in excess of what Milton's services were reasonably worth. . . . The obligation to pay was incurred from year to year after the death of Milton (the employee) and when net income was earned by petitioner from the operation of the St. Louis office, and not before. The expense, therefore, can not be attributed

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[2] 11 TC 569 (1948).

[3] 35 BTA 12 (1936).

[4] 41 BTA 198 (1940).

to earlier years for it was neither paid nor incurred in those years. The liability accrued in 1934."

In a strong concurring opinion in this case, Judge Harron said:

"... the agreement does not state that petitioner agreed to pay ... any *extra* compensation for his services at any time. ... the payments ... represented a pension. ... the Commissioner by his own regulations, has ruled that amounts paid by a taxpayer for a pension to retired employees or to their families or others dependent upon them are proper deductions as ordinary and necessary expenses. Regulations 86, Article 23(a)-9, Act of 1934. It is reasonable to hold that the above regulation applies to amounts paid as a pension to the widow of an employee. The deduction is allowable as a business expense in the taxable year, upon the above stated grounds."

The case of *Astorian-Budget Publishing Co.*[5] is illustrative of a situation wherein payments made to the widow or next of kin of a deceased officer will be held not to be in the nature of a pension and the deduction will be denied. In that case, the officer-stockholders, to protect their dependents, agreed that in the event of the death of any one of them the salary paid each as an officer or director should thereafter be paid to his widow, or next of kin, as long as such widow or next of kin continued to hold the inherited stock. In denying a deduction for payments made under this agreement to the next of kin of one of the officers, the Court said:

"Strictly speaking, no part ... paid ... was a pension. ... the agreement clearly indicates that it was in recognition of services rendered. ... However, the only limitation of time on the payment is the period that (the next of kin) continues to hold the stock. Such a provision bears more earmarks of a special provision for the distribution of profits to an officer-stockholder than it does of a pension payment."

It would appear from these cases that if the payments made to the widow or next of kin of a deceased employee are made under a pension plan or agreement, they are deductible without limitation as to time, as ordinary and necessary business expenses. However, if the payments are not in the nature of a pension, they will bear closer scrutiny and will be allowed for a "limited period" only, if allowed at all. The difficulty arises as to what is a "limited period." IT 3329[6] permitted the deduction by a corporation for payments made to the widow of a deceased officer-stockholder for the years 1937 and 1938. The payments were voluntary on the part of the corporation. During the year 1937 the payments made to the widow were equal to the salary of the deceased employee. During the year 1938, the payments were somewhat less. Nevertheless, the ruling permitted a deduction for both years as coming within the provisions of Regulations, Section 23(a)-9. However, there is nothing in the ruling to indicate that two years is the maximum period permitted.

In *W. D. Haden Company*,[7] the taxpayer was denied a deduction for payments made to a deceased employee's widow. The employee died in 1935. The tax years before the Court were 1940 and 1941. The payments were voluntary and were limited to the widow's lifetime or until her remarriage. The Court sustained the contention of the Commissioner that since the taxpayer failed to show that the payments in question were to be paid for a limited time, Regulation 29.23(a)-9 did not apply and that, futhermore, the payments were not deductible as ordinary and necessary business expenses since the taxpayer had no established policy of paying pensions to widows and there was no evidence that the payments were made for the benefit of taxpayer's business.

In the *Astorian-Budget Publishing*

5 44 BTA 969 (1941).

6 IT 3329, C. B. 1939 2, p. 153.

7 Tax Court Memo, April 9, 1946.

Co. case,[8] the Court held that the period of time was not limited within the meaning of Regulations, Section 29.23 (a)-9, when the only limitation was the period within which the widow or next of kin continued to hold the stock of the corporation. But in the case of *H. T. Cushman Manufacturing Company,*[9] a deduction was permitted the taxpayer for payments made to an officer's widow. In that case, payments were made pursuant to a contract between the corporation and its officers authorizing such payments, in the sum of $5,000 per annum. The contract also contained a provision that the amount of the payments in any year was to be reduced by any dividends paid in that year upon stock of the corporation owned by the deceased officer on the date the contract was executed. The reason for the limitation was that the officers believed that $5,000 per annum would be sufficient for a widow's needs. Payments were to be made during a widow's lifetime, but in no event exceeding a period of 25 years from the date of the contract, August 15, 1933. The widow's husband died in February, 1940. As a payment under this contract, petitioner paid to the widow during the calendar year 1940 the sum of $4,583.33, being 11/12ths of $5,000, no dividends having been paid during 1940. In 1941, sufficient dividends were declared and paid by the petitioner so that only $2,109.58 was paid to the widow under the contract. In 1942 and 1943, no payments under the contract were made, the dividend payments being in excess of $5,000 in each of these two years. Commissioner disallowed the deduction of $4,583.33 paid in 1940, on the grounds that the contract was not a true pension arrangement within the regulations interpreting Sec. 23(a)(1), and were not ordinary and necessary business expenses, but were a distribution in lieu of dividends, relying principally upon the case of *Astorian-Budget Publishing Co.*[10]

The Court, in holding for the petitioner, said:

> "We do not agree with the Commissioner. In our opinion the payments in question are clearly covered by the following sentence of section 19.23(a)-9, Regulations 103: . . . When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs, in recognition of the services rendered by the individual, such payments may be deducted."

The Court distinguished the *Astorian-Budget Publishing Co.* case by pointing out that payments in that case were conditioned upon the widow or next of kin continuing to hold the inherited stock of the corporation and that, therefore, the only limitation of time on the payment was the period during which the widow or next of kin continued to own the stock. No such condition appeared in the agreement in the *H. T. Cushman Manufacturing Co.* case. For this reason the Court refused to hold that the payments were in the nature of a distribution of earnings as in the *Astorian* case.

Is the *H. T. Cushman Manufacturing Co.* case, support for the contention that the "limited period" may be any specified number of years? The agreement in this case provided that payments were to be made for a maximum of 25 years from the date of the contract. However, while the Court specifically referred to the "limited period" mentioned in the second sentence of the regulation, it also went on to call the payments under the agreement a pension. In referring to the provision for the deduction of dividends paid, it said:

> "That provision, however, was simply to the effect that the *pension* would be reduced by the amount of dividends paid on stock owned by the deceased officer at the time the contract was executed. . . . We fail to understand why a *pension* should

8 Footnote 5, *supra.*

9 Tax Court Memo, November 8, 1943.

10 Footnote 5, *supra.*

be regarded as something other than a pension, if it takes into account the recipient's needs, that is, her income from other sources."

If the agreement constituted a pension then it would seem as if there would be no need to apply the second sentence of the Commissioner's Regulations, but that rather the first sentence of such regulations would apply:

"Amount paid by a taxpayer for pensions to retired employees or to their families or others dependent upon them, . . . are proper deductions as ordinary and necessary expenses."

Although the above quoted sentence refers to "pensions to retired employees" it would appear to be equally applicable to pensions paid to widows or next of kin of deceased employees. (See concurring opinion of Judge Harron in *Seavey & Flarsheim Brokerage Co., supra.*)

Summary: Deductibility of Payments

From all present available data, the following would appear to be a fair summary of the deductibility by the payor of payments made to the widow or next or kin of a deceased employee:

1. Payments, to be deductible, must comply with Sec. 23(a)(1)(A) in that they must be ordinary and necessary and reasonable.
2. Payments made pursuant to a contract or plan which can be construed as a pension are deductible.
3. Payments, to be deductible, should be made in recognition of services rendered by the deceased and not primarily to aid the deceased's widow.
4. Payments made, which are not pursuant to a contract or pension plan, are deductible for a limited period if they represent the salary of the deceased employee paid to a widow or next of kin, even though the payments do not equal the salary of the deceased employee. (However they should not exceed such salary.)
5. It is doubtful if the Department will allow a "limited period" in excess of two years although there is some ground for believing that the Courts may uphold a longer period depending upon the circumstances of each case.
6. Contracts to make payments to deceased officers' widows and next of kin who are also stockholders will bear close scrutiny.

Taxability of Receipts

Now to consider the status of such payments to the recipient. At the outset, it is important to note that the non-taxability to the widow of payments received and their deductibility by the payor are not mutually exclusive. Such payments can be tax-free to the recipient and, at the same time, be deductible as a business expense by the payor. Thus I.T. 3329,[11] which permitted a deduction by the payor of payments made to the widow, also held that the payments were tax-free to the recipient. Other rulings have also sustained this determination.[12]

Basically, whether the payments are includible in the income of the recipient or are to be considered as tax-free gifts depends on the intention of the payor.[13] It is immaterial that no services were rendered by the recipient.[14] If the payments made are ***additional compensation*** for past services rendered by the deceased employee, they would appear to be taxable income to the recipient and not gifts. If however they are made ***in recognition of past services*** rendered by the deceased employee, they may or may not be taxable to the recipient, depending on the intention of the payor.

In the very recent case of *Louise K.*

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[11] Footnote 6, *supra.*

[12] O.D. 1017, C B Dec. 1921, p. 101; T.D. 2090, Dec. 14, 1914; L.O. 1040, C B Dec. 1920, p. 120.

[13] *Bogardus* v. *Commissioner,* 302 U.S. 34 (1937). *Estate of Grace McAdow,* 12 TC, No. 45 (1949).

[14] *Varnedoe* v. *Allen,* 158 Fed. (2d) 467; cert. den., 330 U.S. 821.

Aprill, 13 TC No. 92, November 8, 1949, petitioner received payments from her deceased husband's employer pursuant to a resolution of the Board of Directors passed after the husband's decease authorizing said payments in recognition of services rendered by the deceased, at the rate of $1,333.33 per month from January 1, 1942, to March 31, 1943. In March, 1943, another resolution extended the payments to March 31, 1944. Petitioner's husband had been an officer-stockholder of the payor and his salary had been at the rate of $1,333.33 per month. The resolution passed by the Board of Directors was made pursuant to advice by the company's auditor that under I. T. 3329 such payments over a limited period could be deductible by the corporation and not taxable to the recipient. Petitioner, who inherited her husband's stock, became a director and president of the payor corporation but rendered no services to the corporation until April 1, 1944, when all payments in issue had been made. Petitioner did not include in her gross income any of the payments received during the years 1942, 1943, and 1944, covering a period of 27 months. The only question at issue was whether the payment received in 1944 (the last three months), amounting to $4,000, should be excluded from taxable income as a gift or taxed either as compensation for services or as a distribution of profits. The Court held that the payments were gifts and non-taxable to the recipient. Said the Court:

> ". . . the present inquiry must be directed to the purpose which motivated the corporation in making (the payments). . . . We cannot perceive even a remote connection between the payments and services rendered by petitioner, who began employment only after all of the payments in issue had been made. . . . And no obligation of any kind existed to compensate petitioner further for her husband's past services. . . . The facts that the corporate resolution referred to the payments as 'in recognition of his (Anthony Aprill's) services,' . . . and that (the payor) deducted the payments as salary expense on its books and in its returns . . . are satisfactorily explained by the desire of its officers to comply with I.T. 3329 in which identical language was used and identical treatment authorized."

The Court also ruled against the Commissioner's contention that the payments were distributions of profits by pointing out that the other principal stockholder would not have acquiesced in such distributions without receiving his aliquot share.

It is also interesting to note that the Commissioner had denied the payor corporation a deduction for payments made during the final five months, but the taxpayer did not contest this disallowance and, therefore, the issue of what is a "limited period" did not come before the Courts.

Where the payments are made pursuant to a contractual obligation, it is clear that the payments are taxable to the recipient.[15] Under Section 126(a)(1)(B), amounts of gross income in respect of a decedent are taxable to the recipient where the recipient acquires the *right* to receive such amounts by reason of the death of the decedent. Even before the addition of this section to the Code by the Revenue Act of 1942, this view prevailed in Court decisions. In *Flarsheim* v. *U. S.,*[16] deceased had contracted with his employer that upon his death his wife would receive up to $12,000 annually as additional compensation for the remainder of her life. The Court held that the contract vested in the recipient an enforceable right to receive a share of the business income after the husband's death and therefore constituted taxable income to her. Said the Court:

> ". . . the . . . contract vested in appellant upon its execution a right to receive income. . . . Her right was an equitable charge upon the business itself which a court of equity would enforce."

The court also distinguished the payments from an annuity excluded from

[15] *Flarsheim* v. *U.S.,* 156 Fed. (2d) 105, (1946).
[16] Footnote 15, *supra.* See also *Seavey & Flarsheim Brokerage Co.,* footnote 4, *supra.*

income under Sec. 22(a)(b)(2) by quoting 2 Am. Jur.:

> "The grant of the income or interest of a certain fund to a beneficiary during the term of his natural life is not the grant of an annuity, but is simply a grant of profits to be earned, and although directed to be paid annually, such a direction relates only to the mode of payments, and does not change the character of the bequest. An annuity is a fixed sum . . . whereas the income from a fund . . . may vary in amount from year to year and so is necessarily uncertain."

Nor does an enforceable right have to rest upon a contract entered into between employer and employee. It may arise from a purely voluntary plan upon the part of the employer. In I. T. 3840,[17] it was held that amounts received by the widow or heirs of a deceased employee, pursuant to the terms of a voluntary death benefits plan of his employer, represented consideration for services rendered by the employee and, therefore, constituted taxable income to the recipient. Such a plan, according to the Bureau, even though voluntary, is a binding contract according to state laws if based upon services rendered and therefore the payments cannot constitute gifts.

In *Sutro* v. *U. S.*[18] plaintiff received a sum of money from her deceased husband's employer. This sum was a death benefit paid by the employer pursuant to a plan for life insurance and sickness benefits established by the employer, and providing for payments to the dependents of deceased employees based on salary and the number of years served by the employee. The plan stated that it was voluntary and not a factor in the determination of wages; that it could be withdrawn or modified at any time by the employer; but that the employer guaranteed payment of "life insurance" in accordance with the terms of the plan existing at the time of the employee's death. The Court held the payment to be taxable income to the recipient and not a tax-free gift.

> "The existence of the plan was apparently part of the consideration for (the deceased) becoming a full time employee. . . . The 'insurance' plan . . . stated that it was a voluntary plan and could be withdrawn or modified at any time, but 'guaranteed' payment according to the terms of the plan in force at the time of death or disability. The general rule is that a plan of this sort creates an enforceable obligation on the part of the employee or beneficiary even though the plan states that it is voluntary. . . . If there was an enforceable obligation, there was of course no gift, ..."

In *Varnedoe* v. *Allen*,[19] a pension received by the widow of a city fireman pursuant to Georgia statutes was held to be gross income to the widow within the meaning of Code Sec. 22(a) and, therefore, taxable income to the widow, and not a gift or gratuity within the meaning of this regulation exempting from taxation so-called pensions that are mere gifts or gratuities. Said the Court:

> "The payments that the taxpayer received were awarded to her in consideration of services rendered to the City by her husband in his lifetime. They are gross income to her as compensation for services rendered within the meaning of Section 22(a) of the Internal Revenue Code, and in our opinion are not within the exception to the general rule with reference to mere gifts or gratuities."

The Commissioner has also held[20] that the "ordinary death benefit" received by the widow of an employee of the Government of the Territory of Hawaii pursuant to Section 708 (8) (b), Ch. 15, Revised Laws of Hawaii, 1945, represents consideration for services rendered by the employee and constitutes taxable income to the widow. The payment made under that law consists of 50 per cent of the compensation earnable by the husband during the year immediately preceding his death. It is interesting to note that under

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[17] I T 3840, C B 1947—1, p. 7.
[18] D. C. Calif., June 16, 1942, 30 AFTR 1618.
[19] Footnote 14, *supra*.
[20] I T 3972, 1949-21-13207.

Hawaii's law no contribution is made by the employee to the fund from which the payments are made. In the *Varnedoe* case, which involved a Georgia state law, part of the retirement fund from which the payments were made came from payroll deductions from the employee's salaries. A strong dissent in the *Varnedoe* case argued that payment of a pension out of public funds clearly constitutes a gratuity and should not be deemed taxable to the widow and that any tax due on that part of the employee's salary which went into the retirement fund and from which payments to the widow were made was due from the employee and not from the widow. The Commissioner relied on the *Varnedoe* case in his ruling on the Hawaii payments.

As opposed to this, the Bureau in a special ruling dated February 14, 1946, held that stipends granted by a State law to the widows of former governors and the widow of the governor in office at the time of passage of the law were gifts, exempt from tax. This special ruling was handed down without explanation.

Regulation 111 Section 29.22 (a)-2 reads in part as follows:

> ". . . pensions or retiring allowances paid by the United States (unless expressly exempt) or by private persons are income to the recipients; . . . . However so called pensions awarded by one to whom no services have been rendered are mere gifts or gratuities and are not taxable. . . ."

In L. O. 1040,[21] payments made by the Carnegie Foundation for the Advancement of Teaching to teachers and their widows were held to be non-taxable to the recipients because the Foundation was not the employer and no services had been rendered to it. The payments were considered gifts.

Summary: Taxability of Receipts

While some of these views are in apparent conflict, the following would appear to be a fair resume of the taxability to the recipient of the type of payments under discussion:

1. Payments made to the widow representing additional compensation for services rendered by the deceased employee are taxable to her.
2. Payments made as gifts to the widow are non-taxable to her even though they may be deductible by the payor.
3. The payments cannot be considered gifts unless so intended by the payor.
4. An enforceable right in the widow to receive the payments negatives any intent to create a gift.

IT 3329 should serve as a model if it is desired to secure both a tax deduction for the payor and not have the payment considered taxable to the recipient. To accomplish this objective, no contract should be entered into between employee and employer providing for such payments. The presence of such a contract will make the payments taxable to the recipient. It would seem that so long as the payments are in fact voluntary, are not made pursuant to an agreement or enforceable plan, are not compensation for services rendered, and are paid to the widow for a limited period, they will be allowed as deductions and at the same time will be excluded from the gross income of the recipient.

One other aspect of payments to a deceased's widow should be considered: namely, the effect on the estate tax. If the salary is paid pursuant to a contract between the corporation and the decedent, the contract right constitutes an asset of the decedent's estate for estate tax purposes. Since such payments would also be taxable to the recipient, double taxation occurs, which is partially offset by the provision in Code Section 126 (c) which permits a deduction for income tax purposes for that part of the estate tax attributable to the inclusion in the estate of the value of the contract right.

[21] Footnote 12, *supra.*

Statement Accounting for Variation in Working Capital

By John N. Myer

It is possible to prepare a review of what are usually the most significant financial events in the life of a business enterprise during an accounting period by considering the current asset and current liability accounts as a unit and making a summary of the interaction of transactions between this group of accounts and other accounts. And since the net of all the interactions between the current asset and current liability group and the other accounts during a certain period of time is a measure of the increase or decrease in working capital, the resulting statement is one that accounts for the variation in working capital in terms of the various types of transactons that have caused the change.

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The statement under discussion takes no cognizance of the interactions within the group of current asset and current liability accounts. Thus collection of accounts receivable and payment of accounts payable, conversion of accounts receivable or payable into notes, investment in marketable securities, and so forth, are not recorded in the statement. Only those transactions that affect the current asset—current liability group while affecting an account or accounts outside the group are taken into consideration.

The following is an outline of such a statement containing most of the types of transactions within its scope:

The XYZ Corporation

Statement Accounting for Variation in Working Capital

For the Year Ended December 31, 19....

Transactions Increasing Working Capital

(Debits to current asset and current liability accounts; credits to other accounts.)

Sales of merchandise.
Sales of fixed assets.
Issue of stock.
Issue of bonds.

Transactions Decreasing Working Capital

(Debits to other accounts; credits to current asset and current liability accounts.)

Cost of goods sold.
*Expenses.
*Purchases of and improvement in fixed assets.
Retirement of bonds.
Dividends declared (except stock dividends).

* Details may be given.

The difference between the totals of the increases and the decreases shown in this statement is the increase or decrease in working capital as between that at the commencement of business on January 1 and that at the close of business on December 31. The statement, therefore, provides an analysis of the change in the working capital.

An additional section may be added to the above statement in which the change in each current asset and current liability account is tabulated, the net of these changes being the total change in working capital which checks with the causes of the changes listed above. Also, the items may be arranged in various sequences in accordance with the use to which the statement is to be put in a particular instance.

Limitations of the Statement

The scope of the statement is limited to transactions increasing or decreasing the working capital. But since most of the significant financial transactions have either of these effects on the working capital, the statement provides a valuable review of the financial activities of a business. There are, however, various transactions of a rather unusual nature which may be significant in certain cases but which do not come within the scope of the statement, since they do not affect the working capital. Examples of such transactions are: acquisition of fixed assets by issue of stock, conversion of bonds into stock, and declaration of a stock dividend. Such transactions may be reviewed in some other way; they would, for example, be observed in a comparative balance sheet or one of the variants thereof.

Present Status of the Statement

There is probably no subject in all accounting about which there exists as much misunderstanding as this simple statement. The prime cause of the existing confusion of thought is the use of the word *funds*. Although the statement has been given various titles in which that word is included, such as "statement of funds", "statement of application of funds", "statement of sources and disposition of funds", and so forth, a clear definition of the meaning of *funds* as used in the statement has never been given. The word has always been used in a vague manner.

Because of the uncertainty of what is meant by *funds* various writers have indulged in a discussion of its significance. As a result many different definitions of what it is or what it ought to be have been propounded ranging from "cash" to "all resources." After reading several articles on the subject, one gets the impression that once upon a time the word *funds* was cast out into space and now research is conducted to discover its meaning so that the "statement of funds" may be deciphered. It would appear that the searchers are seeking a crime to fit the punishment.

In addition to the inappropriate use of the world *funds* one finds the unfortunate use of the words *provided* and *applied* in an arrangement in which the statement is divided into two balancing sections headed "Funds Provided" and "Funds Applied", leading to the natural assumption, particularly by one not trained in accounting, that the statement shows how much money was received and what was done with it. But such information the statement cannot provide, for it is not a statement of cash receipts and disbursements.

In the provided-applied arrangement an increase of working capital appears as an "application of funds" while a decrease of working capital is shown as a "provision of funds." But to say that funds are provided by a reduction of working capital is paradoxical. The apologist for this method, however, answers that "funds provided by a decrease in working capital" is but a balancing figure and the description of it should not be taken literally. But the non-accountant, for whose information the statement is usually prepared, cannot but believe what he reads.

Then there is the further inept arrangement in which under "provisions" there is listed the net profit to which is added the depreciation charge, because a deduction from income was made for this item although no disbursement was made for it during the period under review. The non-accountant who reads this cannot but assume that the business gets money through the process of depreciation. This has led to the inevitable conclusion in the popular mind that if rates of depreciation are increased the business will have more money available.

Various writers have attributed to the statement certain virtues that it does not possess. For example, one writer has said that it shows what became of the net profit. This it cannot do for the net profit on the accrual basis cannot be accounted for in terms of "funds" whether consisting of cash, working capital, or anything else. Others have said that the statement records all financial changes or the ebb and flow of wealth, but this also is not so since all transactions do not come within its scope.

The statement accounting for variation in working capital has not come into general use because the confused state of the literature on the subject has made it difficult to understand its purpose. Once the confusion of thought has been eliminated and the purpose and limitations of the statement understood it is likely to become a popular tool for business analysis.

AN ADIRONDACK VIEW

Well, we have seen more wintry winters than this one, but never any more taxing tax seasons. Every person and business seems to have had some peculiar transaction, or unusual event, that has tax consequences. Deaths, old stock of unrecorded ancestry sold, corporation liquidations, windstorms and auto wrecks.

Things are always changing. When the tax laws, rates or regulations don't get changed, the precedents of current decisions make things different. Now we have a wave of *Culbertson* case precedents. It is sort of the stylish thing to do—like business men wearing derby hats some years ago.

Have you thought recently of the good old days? Here is a 1926 U. S. Individual Income Tax Return: The income was $2,647, the Federal tax was $12.89 and the New York State tax was $11.61. The single person's exemption was $1,500 on both. The Federal tax started at 1½% and stopped at 5%. The New York tax started at 1% and ended at 3%.

And here is a 1928 U. S. Corporation Income Tax Return: There was a $3,000 exemption, if net income was below $25,360. And the tax rate was a flat (and modest) 12%.

Well, there is one thing in life we are certain of—change. Everybody seems to be working to change something, all the time. Even the CPAs!

LEONARD HOUGHTON, C.P.A.
Of the Saranac Lake "Division" of the Adirondack "Chapter."

A Note on New York State Unemployment Insurance Tax Credits

By Samuel S. Ress

The New York State Unemployment Insurance Law permits employers to establish joint accounts for the purpose of utilizing New York State Unemployment Insurance Tax Credits.

In a recent New York State Unemployment Insurance Referee's decision it was held that the actual utilization of the New York State tax credit by the parties to a joint account was sufficient compliance with the provisions of Section 577.7(b), within the time limited therein.

The facts and issues before the referee were as follows:

On May 13, 1949, a determination was issued, denying the employer's request for a reallocation of a contribution rate credit heretofore issued for the period October 1, 1947, to September 30, 1948, to the joint account of the employer and X Manufacturing Co., Inc., a newly organized corporation. The employer was subject to the Unemployment Insurance Law, and was a qualified employer pursuant to the provisions of Section 577.1(c) of the Law. On May 1, 1948, it transferred some of its functions to a new corporation and discontinued that portion of its business. It received a contribution rate credit for the period October 1, 1947, through September 30, 1948. The new corporation started in business on May 1, and its first payroll report was due on or before July 31, covering the second quarter of that year. It had become subject to the Law as of May 1. The new firm filed its report and attempted to utilize a portion of the credit already issued to the employer. Thereafter, it was advised by the Commissioner's representatives that in order to utilize the credit, it would have to establish a joint account with the employer. On October 1, both firms requested the establishment of a joint account pursuant to Section 577.7 of the Law. The establishment of this account was approved by the Commissioner and covered the period October 1, 1947, through September 30, 1953. Thereafter, both employers filed their payroll reports for the third quarter of 1948, and utilized a portion of the tax credit issued.

On October 29, similar letters were sent to each of the employers by the Commissioner, requesting that he be notified of an allocation of the tax credit by November 30, 1948, in accordance with the provisions of Section 577 of the Law. On November

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Dr. Ress, who has written a number of articles which have appeared in *The New York Certified Public Accountant*, is a member of the Society's Committee on Clothing Manufacturing Accounting.

10, the employers replied requesting that 62 percent of the tax credit in the joint account be issued to the new corporation and 38 percent to the original employer. On December 15, a notice was sent to the employer, advising it that it had utilized more than the tax credit available to it for the period October 1, 1947, through September 30, 1948, pursuant to the allocation made in accordance with its letter of November 10, and that it owed $1,269.83. The new corporation did not utilize 62 percent of the tax credit for that period.

The original employer argued that its allocation outlined in the letter of November 10, was a prospective one on its part, and that it did not believe that the allocation was retroactive to the period October 1, 1947, through September 30, 1948. It contended that at that time the amount of the tax credit utilized by each of the entities had already been established; that the period for which the tax credit could be utilized had already passed; that it could have submitted the actual dollar allocation it desired had it believed that the request of October 29 was retrospective; and that the letter of October 29 to the employers was ambiguous and did not advise the employer for which period allocation was requested.

On December 27, a notice regarding a tax credit issued for 1948 was forwarded to the parties and requested allocation of such credit. Neither replied to that letter. At the hearing, the employer's representative testified that it did not reply to the letter of December 27, because it had already made its election in the letter dated November 10.

The Commissioner's representative argued that the failure of the employer to allocate properly the tax credit issued for 1947-48 was due to its negligence, and that the employer may not be relieved of its consequences. The employer contended that its election of November 10, 1948, was for the ensuing year and was interpreted so to be because of the ambiguity of the letter requesting the allocation.

The referee decided that the original employer's position was well taken. He said:

> "I have noted the contents of the letter of October 29. Nowhere therein does it appear that the allocation was requested for the tax period already expired at that time. When the original employer made its election, the period for the utilization of the tax credit had already passed and it reasonably assumed that the allocation was requested for the ensuing year. Of persuasive significance is the fact that at the time of the election as the period for the utilization of the contribution rate credit had expired, the original employer and the new corporation had the actual dollar value of the allocation it desired. It reasonably assumed that its election for the 1947-48 period had been made known to the Commissioner and that therefore the request contained in the letter of October 29, was prospective. The ambiguity of the letter led to such conclusion. Under the circumstances, I believe that the employer should be relieved of its error and that its request for a reallocation be granted.
>
> "There remains the question of what allocation between the joint account parties should be made. The time limited by the Law for a formal allocation expired on November 30, 1948. No formal request for allocation can be made at present. The actual utlization of the credit by the parties to the joint account was sufficient compliance with the provisions of Section 577.7 (b), within the time limited therein. The employer substantially complied with its provisions. (*Matter of Russian Kretchma Inc.*, 296 N.Y. 945, affirming Appeal Board, 13,101-46)
>
> "The determination is overruled.
>
> "The joint account of the employer should be allocated as reported in its payroll reports."

The $1,269.83 assessment was abated and the taxpayer's failure to comply strictly with the statute was excused.

New York State Tax Clinic

Conducted by Benjamin Harrow, C.P.A.

Information Returns—Personal Income Tax

Spencer E. Bates, President of the State Tax Commission recently indicated that during 1950 the Commission will press for complete and accurate information reports by all New York State employers. Under the Income Tax Law employers are required to report 1949 payments of $1,100 or more to employees who are single or heads of family, and payments of $2,750 or more to employees who are married. These reports are made on Form 105 and should be filed with the Albany office of the New York State Income Tax Bureau by February 15th, together with Form 106, which is a summary and letter of transmittal of Forms 105. Failure to file these information returns subjects employers to penalties under the law. Article 557 of the Regulations provides for penalties of not more than $1,000. In addition, the employer is guilty of a misdemeanor "and shall upon conviction be fined not to exceed $1,000.00 or be imprisoned not to exceed one year or both at the discretion of the court." These penalties may be asserted where the failure to make the return is done with the intent to evade a tax.

The information returns are matched against the individual income tax returns filed by employees. In this way the Commission is able to make some kind of check on the correctness of returns filed. The information returns take into account the optional ten percent deduction to which every taxpayer is entitled, but individuals must nevertheless file income tax returns if they are single and have a net income and net capital gain of $1,000 or more, or if they are married and the combined net income and net capital gain of both spouses is $2,500 or more.

An employer must report payments of salaries, wages, etc., as well as interest, rents, and other fixed or determinable gains, profits and income. In the case of compensation for personal services, the employer must give the social security number of the employee. A corporation that pays interest on its registered bonds must report those payments where they exceed the stated amounts of $1,100 to single payees or $2,750 to married payees. No return of information is required of the payment of interest coupons to bearer.

Payments of dividends are not required to be reported. However, Article 287 of the Regulations provides that the Tax Commission may either specially or by general regulation require every corporation to render a return of dividend payments.

Article 288 of the Regulations enumerates a list of payments that need not be reported. This list includes bills paid for merchandise, professional serv-

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ices, and similar charges. Retainers paid to professional persons on an annual or periodic basis are reportable as fixed or determinable income.

Payments of rent to a real estate agent need not be reported, but the real estate agent must report the payments made to the landlord. That portion of annuities representing income is reportable. Annuities representing the return of capital are not reportable.

Payments made by a broker to his customer need not be reported where these relate to profits made in security trading. As to interest paid or credited to customers, reports are required.

Forms 105 and 106 apply only to payments made to resident taxpayers. If the payments are made to non-resident taxpayers, the employer is required to withhold the tax and Forms 102 and 103 are used to report this information to the Tax Commission.

Returns of Husband and Wife Where Taxpayer Dies During the Year

Normally, a husband and wife may file a joint return if they live together. (Sec. 367) The Regulations (Art. 521) explain this to mean living together for the entire year. Therefore, if one spouse dies during the year a joint return may not be filed. That also had been the federal rule until the 1948 amendments to the Internal Revenue Code, which now permit the filing of a joint return even though one spouse has died during the year.

One of our members wanted to know what returns would be required where a spouse died on January 19, 1949. For the year 1948, a final joint return or two separate returns could be filed for husband and wife by April 15, 1949. In addition, a separate return should be filed for the decedent for the period from January 1, 1949, to January 19, 1949. This return must be computed on the accrual basis even though the decedent regularly reported on the cash basis. (Sec. 358.1) However, like the federal rule, the executor may include such accrued items in a return filed on behalf of the estate if he acquires the right to receive such amounts. If any other taxpayer acquires the right to receive such items by reason of the death of the decedent, such taxpayer may agree to include the accruals in his tax return. The law also provides for the filing of a bond with the Tax Commission safeguarding the payment of the taxes due on such accrued items.

For 1949, the wife will be required to file a separate return covering her own income for the calendar year 1949. Any income the wife may have had for the period from January 1st to January 19th may not be included in the return filed for the deceased husband covering this period.

Something About Domicile

Domicile is a legal relationship of a person to a place. Briefly it is a person's home, which means the place where he lives and has his principal establishment. The concept of domicile carries with it the idea of a fixed place of abode with the intention that it be permanent rather than transitory. If a person has such a home in New York, he gives the state jurisdiction to tax him on all of his income from all sources.

The Income Tax Law taxes all residents, but the term resident includes, first, any person domiciled in the state. (Sec. 350.7) A person may have only one domicile at a time, although he may have more than one residence. The only exception to taxing a person domiciled in New York as a resident is the case where the person has no permanent place of abode within the state, but does maintain a residence without the state and, in fact, does not spend more than thirty days of the year within the state. The state is willing to make this exception principally for the reason that the domicile of a person will give the state jurisdiction to tax his estate at death, regardless of the

fact that he had no home (residence) within the state.

A wife's domicile follows that of her husband, but she may acquire a separate domicile. The latter provision is a modern development since, under common law, a wife could not freely acquire a domicile separate from that of her husband. This provision may result in close situations affecting the extent of the taxability of a person.

Take a situation submitted to us recently: An individual had been domiciled in New York for years. He had a permanent place of abode in New York. It was a home owned by his wife. The wife had a very strong attachment to her family and, in fact, several brothers and sisters lived with the husband and wife in the home. During the war the husband's business interests involved considerable activity in Michigan. In 1946, the husband made up his mind to change his domicile from New York to Michigan. In addition to the fact that homes were not readily available in Michigan, the wife, because of her family attachments, did not wish to give up her home in New York to accompany her husband to Michigan.

To establish a new domicile there must be an intent to change, actual removal, and the acquisition of a new abode. The husband left for Michigan without his wife and set up a new abode either at a hotel or at the home of the manager of a plant. During 1946, the husband did not spend thirty days in New York. When he visited in New York, he of course resided at the home owned by his wife. Has there been a change of domicile that will be recognized by the Tax Commission? According to the taxpayer, there was a change of domicile, the abandonment of the New York domicile, and the acquisition of new domicile. According to the various provisions in the law and regulations taxpayer had probably acquired a new domicile. But what constitutes domicile is a question of fact rather than law and the Tax Commission will look into all the circumstances in determining the question. Weighted against the taxpayer is the fact that the home in New York had not been abandoned. It was the place to which the husband returned when he came to New York. It is true that a wife may have a separate domicile, but other circumstances would have to be submitted to overcome the presumption that the old home had not been abandoned. For example, the place of voting is important evidence of domicile. Other factors would be the mailing address of a taxpayer, statements made in license applications, establishment of business and social contacts. Since the Commission would probably not recognize a change in domicile on the ground that there was a permanent place of abode in New York, the taxpayer would not come within the thirty-day rule. He therefore would still be taxed as a resident on all of his income from all sources.

Some Comments on Form 201

Compensation as an employee is reportable at item 10. Directors' fees would be shown here, but any traveling expenses incurred in connection with attendance at directors' meetings are deductible unless taxpayer elects to take the optional deduction, which is 10% of gross income.

The personal exemption for a single person is $1,000. For a husband and wife the exemption is $2,500, and that is also the exemption for a head of a family, a status still recognized under the state Income Tax Law, although no longer available under the Internal Revenue Code. If the personal exemption exceeds the net income, the excess may be applied to reduce the net capital gain.

A change of residence requires the filing of two returns, a resident return and a non-resident return. However, the tax is not calculated separately on each return. Taxable net income shown on both returns is added together be-

fore computing the tax. The actual computation is made on a rider which is attached to the return.

The form asks for information concerning *changes in net income* made by the Internal Revenue Bureau for 1947 and 1948.

The optional 10% deduction is computed on page 2 of the return. This may not exceed $500 and, if the taxpayer elects to use the optional deduction, he must remember that it is limited to 10% of gross income and is in lieu of all other deductions including other business deductions.

Taxable *interest* includes interest on bonds of other states, even though the latter would be exempt from federal income tax. Under our system of divided sovereignty it would appear that a state has a greater power to tax than the federal government. This is an anomalous situation which the United States Supreme Court will some day resolve.

On so-called tax-free covenant bonds there is no credit for the tax paid at source, such as the federal government allows with respect to such bonds issued before January 1, 1934.

Dividends paid in stock (stock dividends) are not subject to tax. The state rule is more liberal than the federal rule and does not go into the refinements resulting from the *Koshland** decision to determine when a stock dividend is non-taxable and when it may be taxed.

A bad debt recovery is taxable income unless the deduction for the bad debt allowed within a period not more than three years prior to the year of recovery did not result in a reduction of tax.

The proceeds of an endowment policy results in ordinary income, not capital gain, the same as under the federal rule. The difference between the amount received at maturity and the premiums paid is taxed as income.

Deductible taxes include personal payments such as auto registration, New York City sales taxes, the New York State gasoline tax (now four cents a gallon), customs duties, federal admissions taxes, the federal tax on safe deposit boxes, cable and radio messages, telephone calls, and on transportation, the stamp tax on a real estate deed, club dues, etc. The federal luxury tax on fur and luggage is not deductible by the consumer. Neither the federal income tax paid nor the New York income tax is deductible. State and federal stock transfer taxes are deductible, but only as capital deductions for purposes of the separate tax on capital gains. A dealer in securities may, however, deduct such taxes from ordinary income.

Unlike the federal law, *life insurance premiums* are deductible up to $150. A New York resident may take a deduction for *contributions* even though the organization is located outside the state. A non-resident may deduct such contributions only to organizations within the state.

Net Capital Gain Tax

This tax is computed separately from the tax on ordinary net income. The rates are one-half the normal tax rates. Gains are taxable in full, there being no limitation based upon a holding period. Losses are similarly deductible in full, except that no part of a net capital loss may be deducted from ordinary income. However, a net capital loss may be carried over for a period of five succeeding taxable years and offset against capital gains in the later years.

The basis for determining gain or loss in the case of property acquired by gift after December 31, 1927, is the donor's basis. In the case of gifts made prior to that date, the market value on the date acquired is the basis. Worthless securities are deductible only as capital losses. The state law does not disallow a loss by reason of the acquisition of similar or identical securities within a period thirty days before

* *Koshland* v. *Helvering*, 298 U. S. 441 (1936).

or thirty days after the sale of a security (wash sales).

The state law does not allow a deduction for an operating loss sustained in a business either against ordinary income or as a capital loss.

The Unincorporated Business Tax

This is computed separately, on form 202, by every individual or partnership carrying on an unincorporated business within New York. A return is required if gross income exceeds $10,000 or if net income exceeds the exemption allowed of $5,000.

The computation of net income from business is generally similar to the computation for purposes of the personal income tax. The basis for determining losses, bad debts and depreciation is January 1, 1935, the effective date of the Unincorporated Business Tax. Interest and dividends are subject to this tax only if such income is received from assets of a business. Capital gains or losses are included in taxable income if the transactions are connected with the activities of the business. The fair market value of property on January 1, 1935, is a factor in determining gain or loss.

A deduction is permitted for the services of a taxpayer actually rendered. This deduction is limited to 20% of the net income before considering this salary deduction, or $5,000, whichever is lower.

Only income allocable to New York business is subject ot this tax. If separate accounts are maintained for the New York business, the apportionment is permitted on such basis. Otherwise, income must be apportioned according to the factors of real and tangible personal property, wages, and sales. No apportionment is permitted for rents on property located within New York or gains on sale of such property. An allocation is permitted only if the taxpayer has a place of business outside the state.

In the case of a partnership subject to this tax, an exemption is allowed for the interest of a partner to the extent that such amount is included in the net income of such partner, allocable to New York and taxable under Art. 16A (income tax) or Articles 9A, 9B or 9C (franchise tax on business corporations and banks).

The rate of tax is 4% and the entire tax is payable at the time of filing the return.

Proposed Legislation—Deduction for Federal Income Tax

A bill has been introduced in the Assembly (A. B. 196) to permit a deduction from gross income of the federal income tax paid by a taxpayer. For years taxpayers have urged such a bill, particularly since the federal law permits a deduction for the state income tax. The Tax Commission has never approved such a bill, since it would mean quite a reduction in the revenue. If the reduction were too large it might necessitate an increase in the tax rates. The Governor has already indicated that the state will have a deficit in the coming fiscal year and probably he would not look with favor on a measure that would reduce the revenue and so increase the deficit. It should be noted that each year there has been an overall percentage reduction in the tax for all taxpayers (10% for 1948, 40% for 1947, 50% for 1946). There is much to be said in favor of a provision in the law allowing a deduction for federal income taxes paid. If the loss in revenue would be too great, the Tax Commission might consider approving such a measure and eliminating any reduction in the overall tax for 1949.

Proposed Legislation—Real Estate Corporations—Dividends

A bill has been introduced in the Senate (Int. No. 200) to amend Sec. 182.1 of Art. 9. This bill would enlarge the meaning of the term dividend to include "any consideration given by

(Continued on page 173)

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

Proposed Extension of 1934 Act to Certain Unregistered Corporations

The provisions of the Securities Exchange Act of 1934 would be extended to more than a thousand corporations not now affected by the Act if a proposal of the SEC is enacted into law.

The Commission's proposal has been embodied in a bill introduced in the Senate by Senator J. Allen Frear, and endorsed recently by President Truman. It would have the effect of extending certain provisions of the 1934 Act to corporations having more than $3,000,000 of assets and more than 300 stockholders.

Proposal Based on Surveys: In 1946 the SEC made a similar proposal, based on a study it had made which, in the Commission's opinion, pointed to the need for legislation to protect investors in certain unregistered securities. The 1946 study included, among other things, a survey of the accounting practices of a number of corporations not subject to SEC requirements, with a view to determining whether investors in these companies were furnished information which the Commission considers important and which would be made publicly available if these companies were compelled to comply with the reporting and other requirements of the SEC. The current proposal also is based in part on an examination of the financial reporting and other practices of a number of corporations that do not presently file financial statements with the Commission.

Louis H. Rappaport, C.P.A., has been a member of the Society since 1933. He is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A's., and is also a member of the American Institute of Accountants and of the American Accounting Association.

Statement Survey Based on SEC Standards: The principal accounting requirements of the SEC are embodied in its Regulation S-X. For the purpose of evaluating the accounting practices of corporations not subject to its jurisdiction, the Commission used that regulation as a sort of touchstone.

After the 1946 study was published, it was suggested that a fairer basis for evaluating the reporting practices of unlisted companies would be to compare their reports with those sent by listed corporations to their stockholders. The SEC rejected this basis then and has rejected it again principally for the reason that, in adopting Regulation S-X, the Commission has set its minimum standard for financial statements for investors. The financial statements in stockholders' reports of listed companies are not subject to SEC jurisdiction, and these statements, with very few exceptions, do not comply with all the requirements of Regulation S-X. As to such companies, however, the investor or analyst may consult the files of the Commission or obtain photocopies of information required to be furnished by such companies.

Some might be inclined to question the Commission's approach in the present survey since by implication it seems to be critical of the practice of listed corporations in reporting to their stock-

holders. That implication was probably not intended. In using Regulation S-X as a measuring stick, the SEC probably meant to say merely: "In their reports to stockholders these unlisted corporations (which do not file statements with us) omitted certain information which our requirements would have elicited."

Scope of Survey: The staff of Commission in 1946 examined the financial reporting practices of 119 companies which did not file their statements with the SEC. On the basis of the standards established by the Commission, it contended that most of those companies issued financial reports which were in some degree "misleading or inadequate." The new study was undertaken in 1949 and covered 61 of the 119 companies examined in 1946 and in addition 98 new companies, making a total of 159, each of which had assets of more than $3,000,000 and more than 300 security holders. The Commission states "we believe these companies to be a representative sample of such corporations as would fall within the scope of the proposed legislation."

Omission of Prime Financial Statements: Of the 159 companies studied it was found that 19 of them did not publish one or more of the three prime statements which are essential to any analysis of the condition of a business, viz., the balance sheet, statement of income and statement of surplus.

The Balance Sheet: The Commission found 89 balance sheets, judged by its standards, to be deficient. The deficiencies related primarily to disclosures with respect to fixed assets, inventories, reserves and capital stock but there were also such omissions as the failure to report dividend restrictions where such restrictions were known to exist and the failure to segregate receivables into amounts due from officers and employees and amounts due from customers. The Commission was critical of companies which show their fixed assets in a lump sum without indication of whether they were land, buildings, machinery, equipment or some other type. (This break-down is not required by Regulation S-X in balance sheets filed with the SEC, but it is required in a supporting schedule of fixed assets). In several balance sheets the amount of the depreciation reserve was not indicated. Also, the Commission states, "frequently there was no mention of the basis upon which the company carried its assets."

In many of the balance sheets studied inventories were shown as a single figure, and some did not indicate the basis upon which inventories were valued. In many of the reports which showed marketable securities (other than U. S. Government securities), disclosure was not made of market value.

Some companies did not classify surplus as to its source, i.e., earned, capital, revaluation or paid-in.

In those statements that showed reserves other than for depreciation, it was impossible to ascertain in one-half of them the purpose for which the reserves had been established.

A number of the reports did not show the number or classes of capital stock outstanding, or combined the capital stock liability with the surplus account. In a small number of cases the SEC found treasury stock to be improperly shown as an asset; in one report dividends on treasury stock were shown as income to the company.

The Income Statement: Income statements were not furnished by a few of the companies studied, but a large number furnished statements which the SEC said were deficient in material respects. Many companies failed to disclose sales or cost of sales; some of them furnished neither item.

The Commission took exception to those cases which did not show the amount of income before deducting income taxes, and also to those using the "single-step" income statement instead of the conventional form of income statement.

Explanatory Material: The Commission says that financial statements are rarely understandable without explanations, which usually appear in footnotes. As an example of such notes the Commission cites those which deal with the accounting policies followed by a company with respect to disclosure of restrictions on surplus, the basis for determining the depreciation provisions and valuation of inventories. Such explanatory material was absent from the great majority of the statements examined.

Auditors' Reports: In five reports the Commission found the auditors' reports deficient. In two of them the certifying accountant stated that no verification had been made of the inventory amounts and that accounts receivable had not been confirmed; in three cases the accountant said physical tests of inventories had not been made. In each of these reports the certificates stated that the examinations conformed to generally accepted auditing standards.

Nonfinancial Comments: The present proposal to extend the provisions of the 1934 Act to certain unlisted companies is based not only on the Commission's survey of the financial reporting practices of a number of such companies, but also on other grounds. The Commission is critical of the proxy soliciting practices of some unlisted companies. The Commission also believes that the provisions of the 1934 Act designed to protect investors against trading by corporate insiders should be extended to this group of large unlisted companies.

New York State Tax Clinic

(Continued from page 170)

a corporation for the purchase of its own stock in excess of the consideration received by it for the issuance of such stock . . . ." The effect of the amendment would be to subject such excess to the 2% tax on dividends. Since the purchase of its own stock by a corporation can be made only out of the surplus of a corporation, such a transaction in effect is a distribution of surplus and, under the franchise tax law, a surplus distribution is construed as a dividend subject to the additional tax of 2%. Even without the amendment, in the opinion of this editor, the transaction could properly be subject to the tax on dividends. The amendment would eliminate any doubt as to the power to tax such a transaction as in part a dividend.

The Shoptalkers

Conducted by Lewis Gluick, C.P.A.

There was a steady hum of conversation that Wednesday when the Shoptalker arrived. As he gave his belated order he could hear snatches of conversation praising or condemning Truman and Acheson; worries about the white-collar provisions of the new Wage-and-Hour law, effective that day; the impending appearance of both Godfrey and Hope on the same program (and N. B. C. at that); and several other less mentionable things. But gradually Oldtimer's calm voice became dominant.

"That *Haywood Lumber Company* case is not too good for us. The court held that the taxpayer was not negligent. But the C. P. A.—how about him?"

"Reminds me," said the Kid, "of a story they used to tell about a chap who was a big shot in Henry Ford's company before Ford acquired Lincoln. One day he appeared on Detroit's streets driving a Marmon. Some friends met him, and complained. They did not blame him for getting a better car, but why go to Indianapolis for it? Weren't Packard and Cadillac good enough? Why couldn't he patronize his home town and state? The accountant replied that he had been solicited by the Marmon Company. Nobody in Detroit had *asked* him."

"Good story, Kid," said Oldtimer, "and strictly in point. But must we wait to be asked to give our clients advice?"

"It's polite to do so," said Philo.

"It's unprofitable too," said Star. "Awfully hard to collect for unasked advice."

"Well," said Oldtimer, "it's all a matter of tact and tactics, and just like in tax cases, each case must be decided on the surrounding circumstances."

"Let's hear from the Shoptalker," said Philo.

"Thanks," responded the Shoptalker, "but I'm getting chary of expressing myself. Too many editors have censored copy that appeared harmless; too many people are too sensitive about too many things nowadays. Why a year or so ago I published an honest criticism of some teaching methods and was astounded at the reaction I got from teachers. I looked at the matter from a practical viewpoint and I stuck to my opinion: a tax course that does not *familiarize* the students with the forms most used is not preparing them properly for work in public accounting. And you should have heard the squawks I'm still getting from teachers who omit that essential. So I don't want to get into any more controversies which I didn't start."

"Wise man," said Oldtimer. "But have you found any human interest or humor in recent cases?"

"Look!" exclaimed the Kid, "Shoptalker has no patent on finding humor. Let me tell one." Nobody objected.

"There's a case of a man named Snyder. Came out of Pennsylvania right after Christmas. Jury trial de-

Lewis Gluick, C.P.A., who has been a member of our Society since 1924, has resumed the practice of accountancy in the East.

Mr. Gluick, who had been writing under the name of The Shoptalker in other magazines since 1928, recently brought his group of Shoptalkers to our columns. We would welcome your acceptance of his invitation to participate in the discussions.

cided in favor of a father-and-son partnership. There aren't any belly-laughs in the judge's charge to the jury, but there is some good plain language and a number of smiles if you read it relaxed. That judge is *folks*."

"My opinion exactly," said the Shoptalker, "nothing sharply quotable, yet all pleasant. But the best case in years, not for fun, but for opinion, is that of *Kelly*. Judge Jones' conclusion ought to be made compulsory reading for every tax collector, not just I. R. A's."

"Let's hear them," said Oldtimer.

"I came prepared," said the Shoptalker, as he took a memo book from his pocket. "Listen."

> "'By every rule of fair play which we have known from our youth, this tax should not be exacted. The ends of justice require the refund of this tax.'"

"Pungent enough," said Philo, "but how come? What had the Treasury done?"

"Seems a life insurance agent, without authorization, inserted something on the application form which gave the deceased Mrs. Kelly what section 811g calls 'incidents of ownership', and the Treasury would not believe any different. So the executor had to pay over $10,000 in taxes, and now the estate will get back the money."

"With interest, too!" said the Kid. Everybody thought that amusing, so the Shoptalker reports it without giving approval. A lot of things sound funny when said under certain circumstances by certain people, but are dreary in cold type.

Contribution

A member of the New York State Society of CPAs. who describes himself as one of our "rooters" wrote us as follows:

> "I was rather amused on one engagement when the accounts receivable were six thousand out, the reserve for unearned profits ten thousand under, and the reserve for perpetual care out another ten thousand. I was criticized for putting in time trying to locate where the differences arose. They were just written off to surplus and the company went on with a clean slate. Of course, the fact that the shortage in receivables could have represented peculations was of no material value."

Needless to say, our correspondent was not writng from his home state. Furthermore, we hasten to assure him that we know how he feels. Only the Shoptalker can't laugh at such things. Perhaps that's why the Shoptalker is skinny and his "rooter" as round as Santa Claus.

COMMITTEE ACTIVITIES

An Annotated Bibliography on Real Estate Accounting

When the sub-committee started the compilation of this bibliography almost a year ago, its inquiries were met with the reply that there was almost nothing in print on the subject. As its investigation proceeded, however, more and more material was uncovered, and it became apparent that a complete list would require for its publication an unduly large amount of space, and might by its length discourage its use. The following sixty-nine items have been selected from approximately two hundred reviewed. Much good material has necessarily been excluded. The sub-committee has listings on the excluded items and will be glad to make them available to any interested member of the Society.

In making this selection an effort has been made to include adequate material on topics of timely interest, such as current federal tax problems and sell-lease transactions. Nothing has been included which is more than eleven years old. It has been necessary to exclude accounting material not relating solely to real estate, — on depreciation, for instance, there has been in recent years a great volume of literature which is not included here. Standard textbooks and handbooks on accounting and auditing have not been included in this list, nor have the frequent references to real estate companies in the New York State Tax Clinic appearing monthly in *The New York Certified Public Accountant.*

An attempt has been made to classify the included material by subjects but as each is listed only once, it should be borne in mind that many of the items might appropriately be listed under several subjects.

Within the limitations described, it is the hope of the sub-committee that this bibliography may be useful to those interested in real estate accounting. It is of a tentative nature and suggestions will be welcome.

Sub-Committee on Bibliography of the Committee on Real Estate Accounting

MORTON GELLER
THOMAS J. HOGAN
JOSEPH JESPERSEN, *Chairman*

Auditing

GOODMAN, MAX

Insurance Problems in Real Estate Audits
N.Y.C.P.A., July 1949, p. 432-434

Discusses preparation of schedule, adequacy of coverage, status of policies and accountant's responsibility.

GROVER, RALPH FERSON

Auditing Problems Affecting Real Estate
N.Y.C.P.A., June 1940, p. 554-556

Touches on questions that arise in auditing the accounts of owners or agents.

HOLMES, ARTHUR W.

The Auditor's Duty Regarding Fixed Assets and Capital Accounts on a First Audit of an Established Firm
N.Y.C.P.A., November 1946, p. 603-614

Sets forth a detailed audit procedure.

KROHN, THEODORE

Procedures in Reviewing Portfolio of Mortgage Investments in the Audit of a Savings and Loan Association

N.Y.C.P.A., September 1946, p. 507-509

Outlines auditing procedures for mortgages receivable.

ST. JOHN, NEWTON D.

Consideration of Important Assets of Real Estate Companies

Accounting Forum, December 1947, p. 12-16

Points out practical solutions to some auditing difficulties and indicates important technical information that may appear in balance sheets.

SIMON, IRVING L.

Audit of Mortgages

N.Y.C.P.A., April 1945, p. 174-176

Sets forth detailed procedures for the verification of mortgages payable and mortgages receivable.

Closing Statements

KAPLAN, SAMUEL

Standardization of Closing Statements for Real Estate Transactions

N.Y.C.P.A., October 1948, p. 751-756

Presents a proposed statement for closing of real estate sales with comprehensive schedules of adjustments.

Cooperative Apartments

CAMPBELL, ALFRED L.

Accounting for Cooperative Apartment Buildings

N.Y.C.P.A., August 1949, p. 496-498 and p. 514

Discusses budget as basis of assessment, billing, accounts receivable and payable; mentions general ledger accounts.

Developments

KOLIN, SAMUEL

Cost Determination for Small Housing Developments

N.Y.C.P.A., October 1948, p. 744-747

Contemplating a development of 20 to 100 single-family houses, this article discusses costs under four general headings: land, land improvements, construction costs and construction overhead.

ST. JOHN, NEWTON D.

Some Accounting and Tax Problems of Land Development Companies

N.Y.C.P.A., September 1947, p. 587-590

Presents a list of data needed by the acocuntant and discusses accounting procedures.

Federal Income Taxation

AKRE, CHARLES T., and ELLIS, GEORGE P.

Federal Income Taxation and Real Estate, the legal and accounting versions.

National Institute of Real Estate Brokers, 2nd Ed., 1945, 67 pp. Supplement 1948, 8 pp.

Discusses salient features of income tax law, particularly as they relate to the ownership, purchase and sale of real estate; cites cases and court opinions. The section on accounting gives examples. An index is included.

BERGUIDO, CARLOS, JR.

Rental property as "business" property

Taxes, February 1947, p. 112-117

Discussion of tax position of taxpayer not engaged full time in real estate business; review and comment on *Fackler* decision.

BRAUNFELD, FRITZ L.
Real Estate Losses
Taxes, September 1945, p. 828-835
Treats the subject of computing depreciation and gain or loss on the sale of over-encumbered property.
Subject to a Mortgage
Taxes, May 1946, p. 424-446
June 1946, p. 557-561
February 1947, p. 155-161
Discusses tax features relative to sale or exchange of real estate subject to a mortgage.

COWING, JOHN B.
Taxation and Accounting Angles of Modernization
Skyscraper Management, February 1946, p. 8-9 and p. 28
March 1946, p. 12-13, pp. 29 and 30
April 1946, pp. 8, 28, and 29
Discusses allocation of cost to proper accounting periods, stresses need for adequate records, and cites pertinent tax cases.

ENGEL, IRVING M.
Income Taxes and Real Estate
American Bar Assn. Section of Taxation and Practicing Law Institute, 1945, 61 pp.; addenda, 1947, 7 pp.
A comprehensive discussion of current problems in federal taxation affecting real estate owners and operators.
Effects of the *Crane* Case
N. Y. U. Institute on Federal Taxation—1947, p. 379-382
Detailed review of the *Crane* case and conclusions regarding the limitation of depreciation deductions on mortgaged property.

FLEISCHMANN, HENRY L.
Real Estate Accounting vs. Tax Accounting
N.Y.C.P.A., June 1946, p. 316-319
Discusses income tax problems of a real estate owner from purchase of property to its sale and cites cases.
The Allowance of Rentals as Tax Deductions
N.Y.C.P.A., September 1947, p. 591-595
Discusses whether rentals paid must be reasonable, and what constitutes an equity.

GLUICK, LEWIS
How come improvements are not income?
Taxes, February 1946, p. 159-161
Review of income tax features of improvements made by lessee.

LANDMAN, J. H.
Tax Consquences of Real Estate Transactions
Real Estate News, November 1946, p. 380-389; also in
Natl. Ind. Conf. Bd. Business Record, Sept. 1946, p. 378-385
Discusses capital gains and losses and other income tax aspects of the acquisition or disposition of real estate.

LARKIN, GEORGE J.
Tax Pitfalls
Taxes, July 1947, p. 655-659
Discusses income tax status of real estate taxes at time of closing; payments of advance rentals; rental under lease to majority stockholder; liquidation of corporation to save tax.

LASSER, J. K.
Check List for Lessors and Lessees
Taxes, March 1947, p. 140-143
Lists items of income and expense of lessor and lessee and their status for federal income tax purposes.

LERNER, LOUIS
When is one a real estate dealer?
Taxes, July 1946, p. 645-648
A concise review of law and cases dealing with question as to when a taxpayer is a dealer in real estate.

MEYER, CHARLES
Income Tax Problems in Realty Transactions
N.Y.C.P.A., December 1945, p. 647-660; also in
N. Y. U. Institute on Federal Taxation—1946, p. 462-479
Discusses tax problems in connection with lessor and lessee; contract of sale forfeitures and options; capital gains and losses; demolition and abandonment; involuntary dispositions; mortgagors and mortgagees.

Tax Hints for Realty Organizations
N.Y.C.P.A., May 1947, p. 306-312
Discusses the income tax treatment of rents, installment sales of realty, mortgage foreclosure and leaseholders.

MOREHEAD, CHARLES A.
Tax Problems in the Operation and Sale of Real Estate
Taxes, June 1947, p. 513-519
Importance of tax factors in real estate transactions covering consideration of income, estate and gift taxes.

ROEHNER, EDWARD T.
Tax Court in error in holding all rental property "used in trade or business"
Journal of Accountancy, June 1947, p. 477-482
Tax study, tracing history of depreciation deductions and capital asset clasification of real estate, concluding that not all rental property "used in trade or business" is entitled to the benefits of Sec. 117 (j) of I.R.C.

ROSENBERG, MONTAGUE
Advance payments in realty transactions; are they security deposits or advance rentals?
Taxes, March 1946, p. 243-245
A brief analysis of pertinent decisions of the Tax Court applicable to security deposits and advance rentals.

SEGHERS, PAUL D.
Accelerated depreciation and the Treasury's new declining balance method of computations
Journal of Accountancy, February 1947, p. 113-116
Points out disadvantages of the method which permits the use of a depreciation rate equal to 150% of the normal straight-line rate applied in declining balance method.

SILVERMAN, NATHANIEL
Is loss on sale of real property ordinary or long-term capital loss?
Taxes, December 1946, p. 1154-1157
Deals with income tax features of real property sales.

SONKIN, HARRY
Some income tax problems arising from real estate transactions
L. R. B. & M. Journal, March 1947, p. 12-16 (published by Lybrand, Ross Brothers & Montgomery)
Discusses and cites cases re sales of rental property, net operating loss carry-over or carry-back, who is a dealer, and losses on demolition.

SUTTER, HARRY B.
Real estate tax problems
Taxes, January 1946, p. 59-67
Deals with income tax law re sale of real estate, computation of gain or loss, depreciable property, involuntary conversion, rents, lessee's improvements, expenses and capital expenditures, depreciation.

WINSTEN, LOUIS

Real Estate Companies

N. Y. C. P. A., December 1947, p. 796-798, in a panel of experts on year-end tax planning.

Discusses income tax accounting on a cash basis, and for personal holding companies.

Franchise Taxes (New York)

TUNICK, STANLEY B.

Some Aspects of the Real Estate Franchise Tax

N. Y. C. P. A., February 1947, p. 94-98

Discusses the highlights of the New York franchise tax on real estate corporations.

General

AMERICAN INSTITUTE OF ACCOUNTANTS

Accounting for Construction of Building on Leased Land

Journal of Accountancy, November 1945, p. 396

A question submitted to the Institute, with three answers giving analysis of the accounting and tax problems where lessor contributes to cost of improvements.

Accounting for a Real Estate Corporation

Journal of Accountancy, May 1946, p. 426

A question submitted to the Institute, with two answers giving general consideration of balance sheet and discussion of mortgages receivable and payable.

BROAD, SAMUEL J.

Property Accounting

Controller, January 1947, p. 12-15

This article discusses depreciation, cost or other basic value, fortunate purchase, accounting methods, continuity and consistency.

CAMPBELL, ALFRED LISLE

The Managing Agent's Monthly Report on Building Operations

N. Y. C. P. A., March 1946, p. 147-149; also in

National Real Estate Journal, May 1946, p. 28, 36 & 38; and

Buildings and Building Management, May 1946, p. 26-27

Describes concisely a type of report and the records and procedures necessary, with a suggested classification of disbursements.

HIERL, JOSEPH W.

Some phases of Accounting for Real Estate

Transcript, January 1946, p. 1, 6-7 (publ. by Harris, Kerr, Forster & Company)

Factors composing cost of real estate; depreciation comments.

HOGAN, THOMAS J.

Elements of Real Estate and Construction Costs

N. Y. C. P. A., October 1948, p. 748-750

Discusses accounting principles relating to costs of construction applicable to both real estate companies and industrial expansion.

U. S. DEPARTMENT OF COMMERCE

Establishing and operating a real estate and insurance brokerage business

Real Estate Records, 1946, p. 89-95

General review of the scope of the business, regulations to be complied with, sample operating statistics, getting customers, selling property.

Machine Accounting

O'CONNOR, WILLIAM P.

Experiences with Machine Accounting

Real Estate Record and Builders' Guide, April 3, 1943, p. 6-9

Describes the systems used by three large management agents in New York City.

SIDAK, JOSEPH G.
Property records and depreciation accounting on punched cards
N. A. C. A. Bulletin, July 1, 1947, Sec. 1, p. 1352-1358
A brief description of punched cards and related tabulations for items of fixed assets or equipment.

Mortgages

ELSON, BENJAMIN J.
What to do about recording mortgages on the balance sheet
N. Y. C. P. A., June 1940, p. 556-558
Advocates deducting the mortgage on the asset side of the balance sheet when the owner is not "on the bond."

Office Buildings

BEACH, R. B.
Uniform accounting for office buildings
Pathfinder Service Bulletin, October 1939, p. 1, 3-8 and January 1948, p. 1-5
Outlines system developed by National Association of Building Owners and Managers, with forms and method of preparing reports.

CHAN, STEPHEN
Office and Loft Building Accounting and Auditing
N. Y. C. P. A., September 1947, p. 598
Presents an audit program in some detail and general accounting suggestions.

NARBER, F. COLGATE
Outline of Building Management
Buildings and Building Management
Renting office space, December 1944, p. 17-19
Planning the operating budget, January 1945, p. 28-29
The first article considers factors in pricing and presents the Sheridan-Karkow formula for determining rental values; the second reviews the preparation of a budget, with two forms shown.

NATIONAL ASSOCIATION OF BUILDING OWNERS AND MANAGERS
Uniform Accounting for Office Buildings
Buildings and Building Management, June 1945, p. 47-50, and October 1945, p. 41
Describes the system developed by the association; presents chart of accounts and standard operating statement.

Percentage Leases

BUILDINGS AND BUILDING MANAGEMENT
What Percentage for Rent?
Buildings and Building Management, August 1944, p. 37
Tabulated presentation of percentages used by three firms for leases of various kinds of stores where rent is based on a percentage of sales.

GOLDSTEIN, DIANA
Percentage Leases
N.Y.C.P.A., July 1946, p. 372
Discusses problems of the tenant in accounting for percentage leases generally and "fixture rent" and alteration allowances.

JESPERSEN, JOSEPH
Income from Percentage Leases
N.Y.C.P.A., September 1947, p. 596-597
Discusses problems of the landlord in accruing store rentals based on percentages of sales.

McMICHAEL, STANLEY L.

Leases; Percentage, Short and Long Term

Prentice-Hall, Inc., 1947, 585 pp.

Contains much information concerning leases and details regarding specific leases, chain stores, related corporate policies, specimen forms, and pertinent provisions of state laws.

Property Taxes

AMERICAN INSTITUTE OF ACCOUNTANTS

Real and Personal Property Taxes

Accounting Research Bulletin No. 10, June 1941

Presents views of the Committee on Accounting Procedure regarding the date when property taxes legally become a liability, related problems of accrual accounting, and treatment in financial statements; also contains a tabulation of practices of 500 corporations in accounting for property taxes.

DOHR, JAMES L.

Accrual of Real Property Taxes

Journal of Accountancy, May 1942, p. 480

Comment on the *Citizens Hotel Company* case in which the Circuit Court of Appeals upheld the accrual basis used by the taxpayer.

EDELMANN, CHESTER M.

When can accrued taxes be allowed as tax deductions?

Journal of Accountancy, April 1948, p. 328-337

In this comprehensive discussion the introductory remarks and those on property taxes are of particular interest to real estate accountants.

NATIONAL ASSOCIATION OF COST ACCOUNTANTS

Accrual of Local Property Taxes

N.A.C.A. Bulletin, May 1, 1939, Sec. 11, p. 1150-1154

A question submitted, together with six answers, regarding accrual where the taxpayer's and the municipality's fiscal years overlap.

Rent Control

GELLER, MORTON AND GELLER, BETTY R.

1949 Housing and Rent Legislation

N.Y.C.P.A., June 1949, p. 364-369 and 385

Documented statement of legislation on three levels (Federal, N. Y. State and N. Y. City), changes in federal law, and analysis of Form D-106.

GREEN, PAUL M.

Accounting under the new regulations

Journal of Property Management, September 1944, p. 21-28

The director of accounting, O.P.A., discusses the importance of an adequate accounting basis for actions taken to obtain adjustments under federal rent control regulations.

Sale-Lease Transactions

AMERICAN INSTITUTE OF ACCOUNTANTS

Disclosure of Long-Term Leases in Financial Statements of Lessees

Accounting Research Bulletin No. 38, October 1949

The Committee on Accounting Procedure discusses what should be disclosed and when.

AUGSBURGER, WILLIAM N.

"Sell-lease" new source of capital

American Business, December 1947, p. 8-9

Gives details of a number of transactions together with comments from both the points of view.

CARY, WILLIAM L.
Sale and Lease-Back
Harvard Law Review, November 1948, p. 1-41

A detailed discussion of the advantages to the company and to the investor of corporate financing through the sale and lease-back of property, including business, tax and policy considerations.

GREENBERG, GEORGE A.
Sell and Lease Transactions
N.Y.C.P.A., February 1949, p. 98-102

Discusses purposes of various arrangements, recognition of their importance by S.E.C., balance sheet presentation, and income tax problems.

HARROD, SCOTT
Industrial financing through "own-lease";—effect upon the corporate picture
Controller, February 1949, p. 61-64

The author explains and illustrates the effect of an "own-lease" arrangement upon the financial status of a corporation, and concludes that "in general, debt financing is probably better more times than own-lease, but there is a place for own-lease."

KIRCHER, PAUL
Long-Term Leases and the Balance Sheet
Controller, August 1948, pp. 388, 389

Mentions some recent large transactions in financing under a sell-lease arrangement, discusses the various arrangements involved and the need for disclosure.

MYER, JOHN N.
Presentation of Long-Term Lease Liabilities in the Balance Sheet
The Accounting Review, July 1948, pp. 289-295

Presents reasons for showing long-term lease liabilities on the balance sheet, and a method for doing it.

WERNTZ, WILLIAM W.
Buy-build-sell-lease arrangements
N.Y.C.P.A., April 1949, p. 266-267

Quotes Earle King on the Securities Exchange Commission's attitude on various sell-lease methods recently widely used.

Sales of property with a lease back
N.Y.C.P.A., October 1948, p. 772-773

Considers a new species of deficiency from the S.E.C. with respect to sell-lease arrangements, and the necessity for and method of disclosure.

WILSON, JOHN J., JR.
Industrial financing through own-lease:—What—Why—How of the Method
Controller, February 1949, pp. 60, 76, 78, 80, 82

The investment manager of an insurance company explains and comments favorably upon the "own-lease" arrangement of financing.

Bank Costs

(Continued from page 152)

proaches to the problem, will become more prevalent. This would make available to financial institutions increasingly valuable standards of comparison and efficiency guides.

In these days when private enterprise, including the dual banking system, is often placed on the defensive by advocates of socialization and nationalization, it is of the greatest importance that independent certified public accountants and bankers work together to demonstrate that the American way of life is the most efficient, the most productive, and the fairest to the consumer.

In the matter of cost finding and cost justification, which has not always been properly explained to the public, bankers and accountants can see to it that the customer not only pays fairly for what he gets, but even more important, understands what he is paying for.

OFFICIAL DECISIONS *and* RELEASES

DISTRICT COURT

SECOND JUDICIAL DISTRICT

STATE OF MINNESOTA—COUNTY OF RAMSEY

CLIFFORD W. GARDNER, C. PAUL SMITH, CALVIN HUNT, ALRIC ANDERSON, IRVING GOTLIEB, FRED KUEPPERS and WORTH RICE, as constituting all the members of a committee on the Unauthorized and Illegal Practice of the Law, being a sub-committee of the Committee on Practice of the Law of the Ramsey County Bar Association, acting for and on behalf of and by authority of the Ramsey County Bar Association, and for and on behalf of themselves as individual licensed attorneys-at-law, and for and on behalf of every other qualified and licensed attorney-at-law in the State of Minnesota, the Courts and the Public, *Plaintiffs,*

vs.

JAMES L. CONWAY, *Defendant.*

Findings of Fact Conclusions of Law and Order for Judgment

The above entitled matter came on before the undersigned, one of the judges of the above named Court, at a regular Special Term thereof, on December 10, 1948, at the Court House, in the City of St. Paul, Ramsey County, Minnesota. The Plaintiffs had made a Motion to strike out certain allegations of the Defendant's Answer upon the grounds and for the reasons more specifically set forth in the Notice of Motion and Motion which is part of the files, records and proceedings herein.

Each of the Plaintiffs, all duly licensed attorneys-at-law in the State of Minnesota, appeared in person and were represented on the argument and at the trial by the Plaintiff, Clifford W. Gardner of St. Paul. The Defendant was present in Court and was represented by the law firm of Bundlie, Kelley, Finley and Maun of St. Paul, Mr. Joseph Maun appearing, presenting the argument and conducting the trial. The Minnesota Society of Certified Public Accountants appeared as an amicus curiae and was represented by the law firm of Fowler, Youngquist, Furber Taney and Johnson of Minneapolis, the Honorable G. Aaron Youngquist presenting the argument. This Society was also represented by the law firm of Doherty, Rumble, Butler and Mitchell of St. Paul, Mr. Michael Doherty presenting the argument. The Minnesota Association of Public Accountants appeared as an amicus curiae and was represented by the law firm of Best, Flanagan, Rogers, Lewis and Simonet of Minneapolis, Mr. Ward D. Lewis presenting the argument. The State Association of Public Accountants appeared as an amicus curiae and was represented by A. H. Markert of St. Paul, its attorney, who presented the argument.

During the arguments on the Motion herein referred to, it developed that for the best interests of the parties, the convenience of the parties, and the convenience of the attorneys appearing in the case, it would be provident and wise to try all the issues framed by the pleadings and determine the whole controversy on the merits. Upon the concurrent motion made on behalf of Plaintiffs and the Defendant, the case was transferred to the General Term Calendar and the trial of all of the issues proceeded and was concluded on December 17, 1948.

The parties to this action having consented in open court to the transfer of the case to the General Term Calendar and to the jurisdiction of this Court, both as to the person and the subject matter involved, this Court has acquired complete jurisdiction of both the person and the subject matter involved in this action.

After receiving the testimony in the case,

considering the arguments of all counsel, both oral and upon the briefs submitted, and upon all of the files, records and proceedings had to date in this action, the Court, being fully advised in the premises, makes the following:

Findings of Fact

I.

That the Plaintiffs, Clifford W. Gardner, C. Paul Smith, Calvin Hunt, Alric Anderson, Irving Gotlieb, Fred Kueppers and Worth Rice, are now and at all times herein mentioned were attorneys-at-law, duly licensed and authorized to practice their profession in all the courts of the State of Minnesota. That said Plaintiffs are members of the Ramsey County Bar Association and constitute all of the members of the committee known as "The Committee on the Unauthorized and Illegal Practice of the Law," which committee is a sub-committee of the duly constituted "Committee on Practice of Law" of the Ramsey County Bar Association. That Plaintiff Gardner is chairman of said sub-committee and Plaintiffs Smith, Hunt, Anderson, Gotlieb and Kueppers are members thereof, and Plaintiff Rice is the Secretary of said sub-committee.

That the Plaintiffs bring this action as members of said sub-committee, acting for and on behalf of and by authority of the Ramsey County Bar Association.

The Plaintiffs, in addition thereto, bring this action in their individual capacities as duly licensed and authorized attorneys-at-law in their own behalf and on behalf of every other qualified and duly licensed attorney-at-law in the State of Minnesota.

That the Plaintiffs, in addition thereto, bring this action in behalf of the public and of all the courts of the State of Minnesota.

II.

That now and at all times herein mentioned and pursuant to constitutional provisions there is organized, ordained and existing a duly constituted supreme tribunal, commonly called the "Supreme Court of Minnesota." That said Supreme Court has among its inherent powers the sole and exclusive power, right and privilege of saying who shall be licensed and permitted to engage in the practice of the law in Minnesota. That the right to the practice of the law is by sufferance and at the will of the Supreme Court of Minnesota and may be terminated at any time for either the violation of certain laws, the violation of any of the Canons of Ethics applying to an individual, or for any sufficient cause shown. That no other agency, including a duly constituted Legislature, has either the power or right to license anyone to practice or engage in the practice of the law in Minnesota.

III.

That in the year of 1913, the Congress of the United States of America, a law making body created by the Constitution of the United States of America, duly assembled, duly qualified and acting in its official capacity, did ordain, create, publish and establish certain legislation for the purpose of raising revenue, commonly referred to as the "Income Tax Law." That said "Income Tax Law," in its fundamental principles, has been declared by the United States Supreme Court, a court which has been created by the people of the United States when they adopted the Constitution of the United States of America, to be a constitutional law and within the power of the Congress to ordain, create, publish and establish. That constantly since its inception, subsequent Congresses of the United States of America have, on occasions, repealed certain sections of the said "Income Tax Law," and have, on occasions, amended the same in numerous details and particulars. That in addition to the passing of said basic "Income Tax Law," and the amendments thereto, the Congress has duly delegated to the Treasury Department, a constitutional department of the United States Government, the duty, right and privilege of formulating rules and regulations concerning the said "Income Tax Law." That from time to time since its inception, various courts, both of the several States and of the United States, have interpreted and construed the meaning and effect of the several provisions of the said "Income Tax Law." That the Treasury Department has on numerous occasions been called upon to interpret the meaning and has given construction to various provisions of the said "Income Tax Law." That the rules and regulations of the said Treasury Department, unless vacated by a competent Court, have the full force and effect of law. That the foregoing situation in respect to said law, rules and regulations is true now, has existed for a long time in the past, and will continue to exist far into the distant future.

IV.

That in conformance with the mandate contained in the said "Income Tax Law," every person in the United States and every resident of the United States absent from its territorial limits, having an income in excess of certain fixed amounts in the law, is required at various times to make out a report to the Government of the United States concerning said income, which report is commonly called an "Income Tax Return."

V.

That the Defendant is not an attorney-at-law and has never been admitted to the practice of law in the State of Minnesota, or elsewhere, and does not have the necessary qualifications to practice law under the Con-

stitution, decisions and the Rules of the Supreme Court of Minnesota.

VI.

That on the 4th day of March, 1948, and for a long time prior thereto and ever since, the Defendant has held himself out to the public as a duly qualified "Income Tax Expert," specifying himself as being wholly qualified to give advice, aid and assistance to the public generally in connection with the taxpayer's required duty of making out and submitting to the United States of America his "Income Tax Return." That the Defendant advertises through the medium of newspapers, circulars and the like to all and sundry that he is qualified and fitted to act as an "Income Tax Expert."

VII.

That the Defendant does not possess and have the requisite qualifications, of any kind or description, warranting him in holding himself out to the public as being an "Income Tax Expert," and on the contrary, possesses no qualifications whatever, which could allow and permit him to so claim or act.

VIII.

That no exact or comprehensive definition of "ordinary" or "simple" tax returns can be enunciated. That in the majority of "The Income Tax Returns," required by law to be submitted and filed, the preparation requires of the taxpayer only average intelligence, fair knowledge of English and arithmetic, plus some concentration.

That in order for a person to aid and assist a taxpayer in making out an "Income Tax Return" presenting problems properly in the field of law alone, or of both law and accountancy, it is mandatory for such a person to have and possess the knowledge, training and skill found only in the possession of duly licensed attorneys-at-law. That the interpretation of the "Income Tax Law," the interpretation of the rules and regulations made pursuant to said "Income Tax Law" and the interpretation of the decisions of the Tax and other Courts of this and other countries, is the practice of law and within the exclusive field of those licensed to engage therein.

IX.

That on or about the 4th day of March, 1948, the Defendant, without warrant or authority in law, and for a cash consideration then and there paid to him, wrongfully and unlawfully entered into the excluded field of the practice of the law by then and there giving legal aid and legal advice to a certain taxpayer in the following, among other respects:

(a) By determining the legal question as to whether or not the taxpayer was or was not in a partnership enterprise with his wife;

(b) By determining the legal question as to whether or not the taxpayer was entitled to claim his wife as an exemption since the taxpayer had never been ceremonially married, though maintaining a common-law marriage status;

(c) By determining the legal question as to whether or not under the circumstances, the taxpayer should file a separate return and advise his common-law wife to file a separate return;

(d) By determining the legal question as to whether or not certain money spent on improvements of buildings in the business enterprise was or was not deductible from his earnings, and

(e) By determining the legal question as to whether or not a certain produce loss sustained by frost and subsequent flood was a deductible item.

X.

That the Defendant did wrongfully, wilfully and unlawfully prepare, make out and deliver to a certain person completed forms of a United States of America "Income Tax Return," with the intent that such a person would not only rely upon the general and specific legal advice given to him by the Defendant, but would submit and file the said return with the proper United States governmental department and would pay the tax as required in such return.

XI.

That in order to arrive at a decision on the legal propositions heretofore set forth in sub-paragraphs (a) to (e) inclusive, of paragraph IX herein, it was necessary for the Defendant to have recourse to the statutes of the State of Minnesota, the decisions of the Supreme Court of Minnesota, the "Income Tax Law," the decisions of the Tax Court, the decisions of various United States courts covering their interpretations of the "Income Tax Law," and the Treasury Department rulings.

That the Defendant did not possess the requisite knowledge, skill and training to resolve any of the legal problems set forth in sub-paragraphs (a) to (e) inclusive, of paragraph IX, herein set forth; nevertheless, the Defendant assumed, attempted and pretended to answer all of the legal questions herein set forth.

That on numerous occasions, other than those mentioned herein, the Defendant has attempted to and is now attempting to resolve legal problems and give legal advice for a fee, in connection with the "Income Tax Law." That the Defendant threatens to continue to invade the field specifically and by law reserved to duly licensed attorney-at-law.

XII.

That in engaging in the activities set forth and in attempting to perform the services, which Defendant undertook to perform, and which he threatens to continue to perform, unless restrained, the Defendant has gone into the business of the practice of the law. That

if allowed and permitted to hold himself out as qualified to interpret the legality of matters in connection with the compiling and completing of income tax returns involving questions of law alone or of law and accounting combined, the Defendant will be engaged in activities which are in and of themselves inimical to the public welfare.

XIII.

That, unless restrained, the Defendant will continue his regular business of day after day soliciting legal business, giving legal advice to those employing him, and accepting money therefor, all of which is the unauthorized and the illegal practice of the law. That the described activities of the Defendant have been conducted in open, visible and hostile disregard of the rights of these Plaintiffs, and of the rights of those for whom and in whose behalf these Plaintiffs bring this action.

XIV.

That the Plaintiffs have no plain, speedy or adequate remedy at law to prevent the Defendant from engaging in and continuing to engage in the activities forbidden him by the existing decisions, and rules of the Supreme Court of Minnesota. That if Defendant is permitted to continue so to act and to engage in such conduct, it will result in irreparable injury to the Plaintiffs, and to those for whose benefit this action is brought. That the injury and damage already sustained and which will be sustained in the future cannot be readily measured or determined in a pecuniary manner, or compensated for by an action in damages.

XV.

That the Defendant by assuming to act as an attorney-at-law without ever having been admitted to the practice of the law has, by giving legal advice on the important and complex questions presented to him, engaged in the unauthorized and illegal practice of the law, and is in contempt of this Court for so doing, and should be punished for such contempt.

Conclusions of Law

I.

That the Plaintiffs are proper and necessary parties to this action and can legally institute and maintain the same.

II.

That the Defendant is not an expert on the "Income Tax Law," and does not possess any qualifications authorizing him to so claim.

III.

That the Plaintiffs are entitled to an injunction enjoining and restraining the Defendant from holding himself out, directly or indirectly, or assuming, using or advertising himself as an income tax expert, tax counsel, tax attorney, tax consultant, or by any equivalent designation.

IV.

That the Defendant is not an attorney-at-law and has never been admitted to the practice of the law in the State of Minnesota, or elsewhere, but has been unlawfully practicing in law or assuming to practice law.

V.

That the Plaintiffs are entitled to an injunction enjoining and restraining the Defendant from practicing or assuming to practice law in any manner, and in particular from engaging in the giving of legal opinions or advice in relation to tax laws or in connection with the preparing, the assisting in preparing, the making out or the assisting in the making out of tax returns, and in rendering legal services in respect thereto, whether for a fee or charge therefor or not.

VI.

That the Defendant in unlawfully practicing in law or assuming to practice law is in contempt of this Court. That for such contempt the Defendant, James L. Conway, is fined the sum of Fifty ($50.00) Dollars and is directed to pay the fine to the Clerk of this Court on or before ten (10) days from the service upon the Defendant and upon his attorneys of record of a certified copy of these Findings of Fact, Conclusions of Law and Order for Judgment, with written notice of the filing of the same.

LET JUDGMENT BE ENTERED ACCORDINGLY.

(signed) Albin S. Pearson
District Judge.

Stay of forty (40) days granted.

Dated at St. Paul, Minnesota,
this *23* day of January, 1950.

Memorandum

Among the exhaustive briefs three have been submitted by organizations as Amici Curiae. One is on behalf of the Minnesota Society of Certified Public Accountants whose members have been certified under M.S.A. *326.17-23*. The second is on behalf of the Minnesota Association of Public Accountants whose members are engaged in public accounting on a full time basis. The third is on behalf of the State Association of Public Accountants whose membership requirements I do not know. Some of the matters discussed in those briefs are not strictly germane to the issues in this case because

"It is the duty of this court so to regulate the practice of law and to restrain such practice by laymen in a common sense way in order to protect primarily the interest of the public and not to hamper and burden

> such interest with impractical technical restraints no matter how well supported such restraint may be from the viewpoint of pure logic." *Cowern v. Nelson, 207 Minn. 642, 290 N. W. 795,*

and any rule requiring every Federal Income Tax Return to be prepared by a licensed attorney and counselor-at-law would be impracticable. Also, no exact and comprehensive definition of "practice of law" nor of an "ordinary" or "simple" tax return can be enunciated; and whenever definition is given, it must be limited by application to the facts of a particular case. Most likely, in the overwhelming majority of returns the preparation requires of the taxpayer only average intelligence, fair knowledge of English and arithmetic, plus some concentration and patience. The fact that many taxpayers do not possess all of those attributes and some have none and therefore must have the advice of others does not make the rendition of such advice the practice of either law or accountancy.

Beyond that class of returns which I designate as "the more numerous", and not as "simple" are three classes presenting problems properly in the field of (1) law only (2) accountancy only and (3) both law and accountancy. While there is no such express admission in any brief, my analysis leads me to conclude (1) that in no brief is it claimed that the acts of the Defendant fall into the class referred to as "the more numerous", (2) that the Plaintiffs' claim that while the acts of the Defendant included the preparation of a return which was a "reckoning" or "calculation" or "rendition of account", he was not in the field of accountancy for his accounting was merely a vehicle through or on which he carried on work which was in the field of law only, and (3) while the Defendant does claim that the return was a "simple" one, his basic claim, as well as that of each Amicus Curiae is that the preparation of the return falls within class 3 above, the field of both law and accounting and that the Defendant's acts in the field of law were proper because incidental to the accounting.

I disagree with the broad claim of the Minnesota Society of Certified Public Accountants as applied to the facts here that

> "the making of income tax returns and giving advice on tax laws and regulations in connection therewith does not constitute the unauthorized practice of law,"

although I agree with a great deal of what is said in its brief, especially that in business problems involving questions of accountancy and of law it is advantageous generally and absolutely necessary sometimes to engage both an accountant and a lawyer, to let them adjust the division of effort and responsibility so as to obtain the benefit of each practitioner's skill and judgment as regards matters within his grasp. Also I disagree with the claim of the Minnesota Association of Public Accountants that

> "the preparation of an income tax return and decision of the various problems incidental thereto is an accountant's task,"

unlesss the word "return" refers only to one of "the more numerous" kind, or to one in the field of accountancy only. And I see no basis whatever for the claim of the State Association of Public Accountants that

> "it must be recognized that to one having the qualifications of an accountant all tax returns are likely to be relatively simple. * * * It would seem that where in a tax case you have gotten beyond the filing of the return and the explanation of it, the conference and the informal hearing, and when you come to where a record is to be made which may be used in an appeal to the courts that then the lawyer should be consulted,"

because I have read no case which does not assume that the practice of law includes the giving of advice even though no appearance in court is necessary, desired, or contemplated.

Most of the foregoing is really immaterial to the issues in the case at bar. Notwithstanding that, it is submitted in grateful acknowledgment of the kind offer of help by the way of fine briefs presented on behalf of a great, though new, profession which has standards not wholly unlike those of the older legal profession. As I see it, the issue before me is not whether an accountant may or may not legally prepare a return. Because in each brief and in this memorandum that issue and the Bercu case have been considered, I may, perhaps with no impropriety, say that my views coincide with what is said in the Bercu opinion and the following comment thereon in 33 Minnesota Law Review, at 445:

> "Although courts uniformly hold that preparation of tax returns by laymen is not 'practice of law,' they are careful to limit their decisions to the particular returns considered. Thus, while the layman can prepare a return of 'the least difficult kind,' he must stop when a doubtful question arises requiring construction of a statute or consideration of a decision. In the course of preparing a tax return, the accountant's client often requests advice. The nature of the request seems to determine whether or not the advice is permissible. If the accountant, having all the facts before him, gives advice on the necessity of filing a return, or conveys information describing tax laws and methods of making tax returns, he is not practicing

law. However, if the advice is given not incidental to the preparation of a return, whether in regard to certain tax deductions, as in the instant case, or to a statutory interpretation permitting certain refunds, it is unauthorized practice of law. * * * Lawyers and accountants concede that in the field of taxation the line of demarcation between the two professions is difficult to draw,"

except that I disagree with the following sweeping language in the last sentence of that comment:

> "But, in effect, the line has been drawn with respect to the preparation of tax returns and the appearance of accountants before tax commissioners in efforts to secure refunds for their clients."

because, as stated above, the practice of law includes the giving of advice respecting the construction and application of statutes and decisions even though no appearance before a formal tribunal is necessary, desired, or even contemplated. It seems to me that no "line has been drawn" and that none can be except in each case when presented and then only as respects the facts in such case.

The evidence shows that the Defendant held himself out to, and for a monetary reward actually did, advise as to whether or not a common law marriage and a partnership existed and as to whether or not the cost of a heating plant and of a roof, and damage to crops were deductible. In my judgment, this constitutes unauthorized practice of law. It seems also clear that the Court not only has the power, but for the protection of the public, it is compelled to punish a person not licensed to practice law for dispensing legal advice on such important and complex questions. In this case, the Defendant's qualifications are based upon an eighth grade education, selling insurance, operating a collection agency, managing a hardware store and doing other dissimilar work in no way whatever relating to law or law education, training or experience. For three years he was employed in the office of the Collector of Internal Revenue and undoubtedly became proficient in the purely clerical or routine aspect of tax returns. Whatever he did in any of these activities could not possibly give him the necessary training in the fundamental principles, history, development, and application of law in general or in any of its branches in which he gave advice for a professional fee. For more than a hundred years it has been almost universally considered that training, comparable with his, is an insufficient basis to enable a person to construe statutes, decisions, and legal documents without grave risk of harm to persons advised by him.

(signed) Albin S. Pearson J.

(Continued from page 137)

Credit Management Year Book (Volume 15)

Published by The Credit Management Division of the National Retail Dry Goods Association, New York, N. Y., 1949. Pages: 448; $6.00 members; $10.00 non-members.

The new 1949 edition of the Credit Management Year Book, just published, is available for distribution. Mr. A. Leonidas Trotta, manager and research director of the Credit Management Division of the National Retail Dry Goods Association, who edited the book, has compiled within its 35 chapters the views of 86 experts on every phase of retail credit.

Far from being "just another credit book," the current issue of Credit Management contains many new and stimulating ideas on the all important topic of 1950 retail credit. Up-to-date information about successful plans to increase credit sales by proper credit sales promotion techniques, effective methods of expense control, and the ever-present problems of collections are discussed.

Considerable space is devoted to branch store credit procedure, a timely and new topic. Presented in detail is a valuable report of the first complete clinic of branch store operation and the results of a survey on this subject.

Other ever-present problems of the Retail Credit Department are covered, including Retail Credit Management, Installment Credit, and Credit Bureau Relations. They are given their full share of space, to enable the credit man to face the very important year of 1950, with the thorough knowledge of the experiences and "know how" of credit men who have solved some of these problems in 1949.

The year 1950 looms ahead as a crucial one for the retail store both large and small, and a recent survey indicates that management is going to try to attain two definite goals in the credit division. One, greater expense control and, two, more sales volume.

Numerous chapters of the 1950 year book demonstrate in a very stimulating way how the credit department, by utilizing its credit services, can make them an exceedingly constructive force in increasing sales volume in a period when business is hard to get. The importance of this in the forthcoming year should not be overlooked, but to be successful this promotion must be well planned.

Expense control, especially in the credit department will unquestionably be of major importance in 1950, and the current issue of the year book covers this thoroughly, by having experts discuss job analysis in the credit department, production figures, and how to plan and control an expense budget.

Of invaluable help is a complete section devoted to collection problems and, in addition, there is a reproduction of collection letters of proved effectiveness and a chapter on how to improve your present collection letters.

Mr. Trotta has again come forth with a book that has hit the bull's-eye. Now, as never before, this book is a must, and its complete coverage of small and large store operations will prove to be a tremendous help to credit managers and accountants in arriving at solutions to the problems discussed.

Albert S. Kleckner

Namm's, Inc.
Brooklyn, N. Y.

Accounting & Tax Problems in the Fifties

Technical Papers from the Sixty-Second Annual Meeting of the American Institute of Accountants (Los Angeles, California; October 31-November 3, 1949), American Institute of Accountants, New York, N. Y., 1950. Pages: 110; $1.00.

Twelve technical papers, including five on various aspects of federal taxation, comprise this year's collection. The titles and authors' names are as follows:

Investigative Procedures in Audits for Embezzlement
—*Leonard B. Johnson, CPA*

Auditing Inventories and Receivables of Smaller Clients
—*Clifford V. Heimbucher, CPA*

What Are Adequate Financial Statements for Credit Purposes?
—*T. W. Johnson*

Significance to Accountants of Changes in Government
—*Norris Poulson, CPA*

The Hoover Commission and Economy in Federal Government
—*John W. Hanes*

Some Trends in the Interpretation of Business Profits
—*Neil H. Jacoby*

Study Group on Concept and Terminology of Business Income
—*George O. May, CPA*

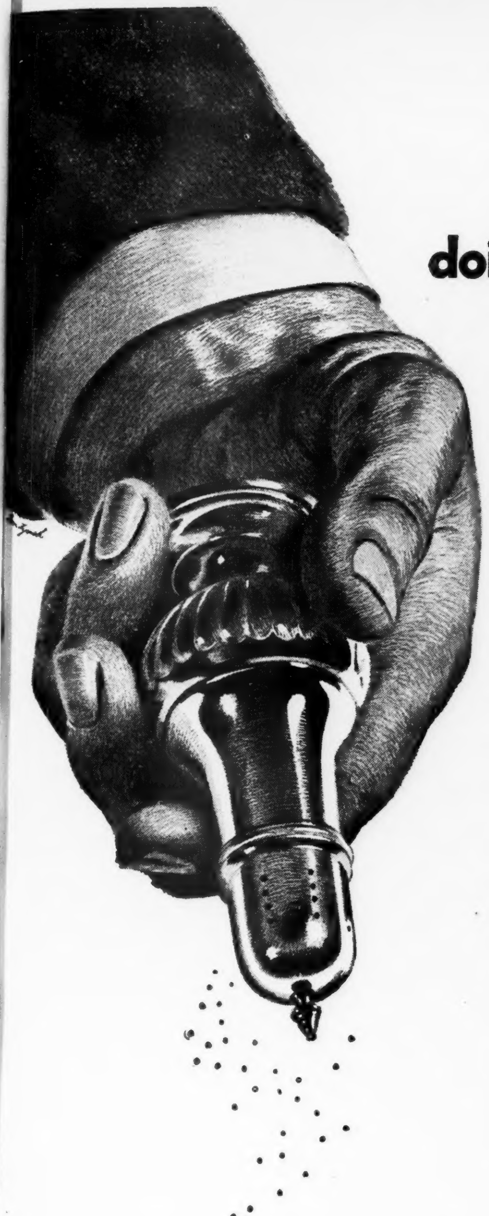
Tax Settlement Procedures—General Considerations
—*Mark E. Richardson, CPA*

Tax Settlement Procedures from a Legal Point of View
—*Charles D. Hamel*

Tax Settlement Procedures — from the Government Point of View
—*Aubrey R. Marrs*

A Review of Some Recent Tax Decisions and Rulings
—*Russell S. Bock, CPA*

Problems in the Determination of Taxable Income
—*Wallace M. Jensen, CPA*



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BOOK REVIEWS

Accounting Systems

By Oscar S. Nelson, Ph.D. and Arthur D. Maxwell, C.P.A. Richard D. Irwin, Inc., Chicago, Illinois, 1950. Pages: xv + 699; $6.00.

This book is essentially an integrated description of accounting systems of a series of enterprises. Of a total of 35 chapters, only the first three treat of accounting systems, design and installation in general. The remainder of the volume deals with the "nature, organization and accounting problems" and the accounting systems of eight specific types of undertakings. These were selected for their value in illustrating solution of accounting problems of some general applicability.

The following eight types of enterprises are analyzed:

1. Savings and loan associations. Their problems "revolve around the receipt and disbursement of cash." An incidental, but important element in its general applicability, is the computation of dividends.
2. A fire insurance company, study of which offers opportunity for drills in periodic adjustments.
3. Banks. While their accounting problems are related to the receipt and disbursement of cash, the variety of functions of banks commonly require departmentalized organizations. Internal check is also a significant feature.
4. Stock brokerage houses, with emphasis on the dual system of accounts required; for cash and for securities. This serves as another step in the transition from the system in which the cash book predominates to more complex accounting systems.
5. A department store. Stress here is on the handling and control of merchandise and the problems of expense classification and distribution.
6. A manufactured gas company, to represent both a public utility and a manufacturing enterprise. Cost accounting problems are omitted with the thought that they usually furnish the basis for a special course.
7. Steam railroads. They are public utilities but differ from a gas company in that they are connected with transportation and operate over very much wider areas.
8. A municipality, as representative of governmental units with their own specialized type of accounting.

(Continued on page 198)

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Book Reviews

(Continued from page 196)

Each kind of undertaking has been quite thoroughly treated in terms of its nature, accounting problems, account classification, books, forms and procedures. There is also considerable exercise material. The exercises are designed, however, to develop an understanding of the account relationships in the given enterprise; that is, the exercises call for journal entries, statements, schedules, or computations. Except for several exercises in the third chapter, there does not appear to be any which call for such matters as preparing a classification of accounts or designing a form or planning a schedule of office operations.

The authors indicate two possible approaches in a course on accounting systems: the constructive, wherein one considers the steps to be taken in designing and installing a system and the underlying reasons; and the analytical, in which one works toward an understanding of systems in actual use and the manner in which these systems provide solutions for the accounting problems of the specific enterprises. Both approaches are employed, according to the authors. The emphasis, however, in the opinion of the reviewer, is on the analytical.

"Accounting Systems" is a well-designed course text; it would also serve as a valuable addition to a practitioner's reference library.

DANIEL LIPSKY

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Proceedings of New York University Eighth Annual Institute on Federal Taxation (November 9-18, 1949)

Paul A. McGhee, Dean, Division of General Education, and J. K. Lasser, Chairman, Institute on Federal Taxation. MATTHEW BENDER & COMPANY, INC., Albany and New York City, N. Y., 1950. Pages: xviii + 1361; $22.50.

The volume contains most of the papers presented at New York University's Eighth Annual Institute on Federal Taxation. The oral presentations have been expanded to full length papers and have been supplemented by the addition of copious footnotes, references and citations. This yearbook of the best thinking and research on tax problems of current importance contains 124 articles grouped under the following headings:

Intercorporate Operations—Tax Problems Arising in the Dealings Between a Parent and its Subsidiaries, Related Companies, etc.

(Continued on page 228)